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REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

HEARINGS

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

S. 2045

A BILL TO AMEND THE COMMODITY EXCHANGE ACT TO REAUTHORIZE APPROPRIATIONS TO CARRY OUT SUCH ACT, AND FOR OTHER PURPOSES

FEBRUARY 19 AND 20, 1986

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REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

WEDNESDAY, FEBRUARY 19, 1986

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The committee met, pursuant to notice, at 9:40 a.m., in room 328-A, Russell Senate Office Building, Hon. Richard G. Lugar presiding.

Present: Senators Helms, Lugar, Hawkins, Andrews, Wilson, McConnell, Zorinsky, Leahy, Melcher, Dixon, Heflin, and Harkin.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Senator LUGAR. This hearing of the Senate Agriculture Committee is called to order.

I welcome each of you this morning to this hearing of the Senate Committee on Agriculture, Nutrition, and Forestry to discuss the reauthorization of the Commodity Futures Trading Commission.

For many years, our futures markets have played an important role in the economy by facilitating hedging and pricing activities. It is vital to the well-being of most businesses and to the entire economy of this Nation that the futures industry continue to receive efficient and effective oversight; oversight that promotes confidence among those who look to the futures markets in order to minimize business risk while encouraging vital participation by risk takers and speculators.

The reauthorization of the Commodity Futures Trading Commission provides an opportunity for Congress to review the activities of the Commission and to reexamine and refine its regulatory authority.

This committee worked for several months in 1982 to produce a far-reaching reauthorization bill. While I do not expect significant amendments of the Commodity Exchange Act this year, I intend to carefully review each provision contained in S. 2045,[1] along with many more controversial regulatory decisions issued by the Commission in its enactment of the 1982 amendments.

The Commodity Exchange Act was amended in 1982 to give the CFTC far greater powers to regulate a very growth oriented industry. In addition, the industry's self-regulatory body, the National Futures Association, was given more authority to assist with various aspects of the regulatory process. State and local officials were given full authority to control the sale of off-exchange instruments. The hearings will focus primarily upon these enforcement powers, whether they are inadequate, given the continued growth in futures trading.

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[1] See p. 371 for a reprint of S. 2045.

I would simply indicate to those scheduled to testify that our willingness to hear witnesses today and tomorrow will be governed in part by the schedule on the floor, and I am going to rely upon my good colleagues to be of assistance so that the hearings are as complete as possible.

I understand this morning that the distinguished chairman of the committee will appear about 10:30 or 10:45 and will be able to take charge of the hearing while I go to the floor to manage the Philippine resolution. As members know, we are discussing also the genocide treaty, and my understanding is that it will commence shortly after our vote on the Philippines.

We will, however, proceed as rapidly as we can today with witnesses. We have asked Chairman Phillips to give some summary remarks, if she can, and submit to questions by all members, and then each of the additional witnesses to have a 7-minute time limit on oral testimony so we can get quickly to questions with the understanding that all testimony, of course, will be made a part of the record.

Senator DIXON. Mr. Chairman.

Senator LUGAR. Senator Dixon.

STATEMENT OF HON. ALAN J. DIXON, A U.S. SENATOR FROM ILLINOIS

Senator DIXON. I am almost embarrassed to ask for this consideration, Mr. Chairman. But like all of us, I have several committees meeting this morning. My problem is that I have a major amendment to the DOD reauthorization bill before the Armed Services Committee in markup. I would like to go there as expeditiously as possible.

My colleague in the chair—who is from my neighboring State of Indiana—I know understands that 80 percent of the futures trading takes place in my State. So there is a matter of tremendous importance in this hearing to my State, and probably to your own State as well. May I ask the Chair if I could have the privilege of asking one or two questions of the Chairman, when she testifies, regarding our concerns about this audit trail question, before I leave the hearing this morning?

Senator LUGAR. Of course.

Senator DIXON. I thank the Chair.

Senator LUGAR. With the cooperation of all my colleagues, we will move your question expeditiously, and I will ask at this time for any comment or opening statement from my colleague, Senator Zorinsky, the distinguished ranking member.

Senator ZORINSKY. Thank you, Mr. Chairman.

I am glad that the committee is holding hearings to consider legislation relating to the CFTC. This legislation is very important; the futures markets are an integral part of the Nation's economy.

Mr. Chairman, in the interest of time, I ask that my statement be included in the record.[1]

Senator LUGAR. Without objection.

The Senator is very gracious.

Senator Melcher, do you have an opening thought?

Senator MELCHER. None.

Senator LUGAR. Senator Dixon.

Senator DIXON. I have a statement I will place in the record.[2]

Senator LUGAR. Very well. By unanimous consent it will be placed in the record.

Senator Heflin.

Senator HEFLIN. I have no statement.

Senator LUGAR. Thank you.

I would like to call to the witness table the Honorable Susan M. Phillips, Chairman, Commodity Futures Trading Commission, Washington, DC.

It is a very real pleasure, as always, to have you here, and we would like you to proceed immediately with your comments and then be prepared for questions. I know Senator Dixon for one has a question or two for you this morning. We are delighted that you are here.

STATEMENT OF HON. SUSAN M. PHILLIPS, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Ms. PHILLIPS. Thank you very much, Mr. Chairman and members of the committee.

Let me say, first of all, I am pleased to come before you today representing the Commodity Futures Trading Commission to present our reauthorization proposal.

I would like to mention that Commissioner Kalo Hineman also is warming the bench back here, and my other colleagues are back at the ranch, so to speak, working.

The Commission's reauthorization legislative request this time is really quite brief. We are proposing what we believe to be minor changes to the Commodity Exchange Act, unlike the requests made in the sunset reviews of 1978 and 1982. Major revisions to the act were made in those years, and the Commission simply does not see the need for such changes at this time.

In addition to discussing the legislative proposals, I would ask your permission to submit two items for the record. First of all, a supplemental statement detailing our experience with the amendments that were made to the act in 1982, and discussing some of our recent regulatory activities, as well as the Commission's explanation of the legislative requests that we have made.[3]

Senator LUGAR. Without objection, that will be placed in the record.

Ms. PHILLIPS. Thank you very much.

As you mentioned, the legislative changes we propose are contained in S. 2045, and the bill is really composed of four parts: the first part dealing with enforcement and appellate review issues, then leverage transactions, registered futures associations, and miscellaneous amendments.

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[1] See p. 164 for the prepared statement of Senator Zorinsky.

[2] See p. 166 for the prepared statement of Senator Dixon.

[3] See pp. 167–209 for the prepared statement and additional material of Ms. Phillips.

I would like to begin with a brief description of the Commission's proposals in the area of enforcement and appellate review.

One of our proposed amendments would alter section 4(b) of the act, which generally prohibits cheating or defrauding in connection with any contract or sale of a commodity for future delivery made on or subject to the rules of any contract market. The Commission is concerned that this language may be interpreted narrowly to limit our authority to exchange-traded futures, resulting in a court's refusal to apply section 4(b) to the sale of off-exchange futures contracts. The amendment would not expand the Commission's jurisdiction, nor would it in any way reduce the authority of the States to move against off-exchange fraud operations. This amendment would simply make it clear that both the Commission and the States have the authority to prosecute fraud committed by off-exchange futures operators.

Our second proposal in the area of enforcement would amend section 6(b) of the act expressly to authorize the Commission to serve investigatory and other administrative subpoenas on persons outside the territorial United States. We believe the proposed change is necessary in light of a recent decision of the U.S. Court of Appeals for the District of Columbia. The court ruled that section 6(b), as presently drafted, does not authorize enforcement of an investigatory subpoena served on a foreign citizen in a foreign country. The appeals court did not question the authority of the Congress to so authorize the Commission, but rather rules that the Congress had not granted such authority when it enacted section 6(b).

The Commission believes that its investigatory capability may be seriously compromised by this decision, and we request an amendment to 6(b) clarifying that investigatory subpoenas can be served on U.S. market participants even though they are outside of the territorial United States.

In our third enforcement proposal, the Commission requests statutory authority to seek the ex parte appointment of a receiver when it seeks an ex parte freeze of a firm's assets. Section 6(c) of the Commodity Exchange Act authorizes the Commission on an ex parte basis to obtain a restraining order to freeze the assets of persons it believes have engaged in, or are about to engage in, a violation of the act or Commission rules, and to prevent such persons from destroying books and records. As the section is presently written, however, there is no express power for the Court to appoint a receiver on an ex parte basis to protect and manage the business of the firm subject to the freeze order.

Often, the period between the issuance of the ex parte restraining order and the hearing on the application for appointment of a receiver can be as long as 15 to 20 days. During that time, the restrained operation may hold open positions in the futures market that would go unmanaged. In addition, while assets are frozen, employee salaries may go unpaid and employees may quit, further limiting the ability of the operation to preserve any assets on behalf of customers. A temporary receiver could pay salaries and other legitimate expenditures, meet margin calls or liquidate unprofitable positions, and otherwise protect the assets of the operation for ultimate distribution to customers.

In the area of appellate review, the Commission proposes to add a new section to the act to allow persons aggrieved by a final Commission order or rule to obtain review of that order or rule only in a U.S. court of appeals. If adopted as drafted, the amendment would eliminate the current two-step procedure that permits an appeal to begin in a U.S. district court.

In the course of issuing many of its final orders and rules, the Commission employs a number of administrative procedures which, in many ways, are analogous to the function of the district court in gathering and weighing evidence in disputed matters. Review by a court of appeals would provide for a definitive ruling more promptly and save judicial and Commission resources, as well as the resources of the aggrieved party.

The second title of the bill would eliminate the Federal regulation of leverage transactions under the Commodity Exchange Act.

Because off-exchange trading is not subject to self-regulatory oversight and has been associated with allegations of fraud and high pressure sales resulting in numerous customer complaints, Congress and the Commission historically have been concerned with off-exchange instruments and have proceeded cautiously in this area. The Commission's comprehensive leverage regulations have been in effect since April 1984, although the regulations were phased in over a period of time. Under the Commission's moratoriums on new firms and new products, two firms are currently operating as CFTC-registered leverage transaction merchants. The application of one other firm is currently before the Commission.

In developing its leverage recommendation to the Congress, the Commission considered two other feasible alternatives: First, retaining the current moratoriums, and, second, lifting the moratoriums on new entrants and products to the leverage business, provided that certain regulatory responsibilities are assumed by the NFA. While there was some support on the Commission for the second alternative, the Commission ultimately voted to recommend the elimination of leverage regulation by the CFTC.

This recommendation reflects the Commission's concern with the expansion of off-exchange instruments and the required commitment of resources which could be dedicated otherwise to overseeing the futures industry.

Recognizing the potential effect on the two existing regulated firms, the Commission could, by taking a no-action position, allow time for these firms to adjust their businesses to conform to State regulatory structures—most likely under the model State commodity code that many States currently are considering. These firms could establish businesses offering commodities on some kind of cash and carry basis or installment purchase plan.

In sum, the Commission believes that the sale of futures contracts should occur on exchanges under the supervision of self-regulatory organizations. Adoption of this recommendation would eliminate what the Commission perceives as the historical and unjustified distinction between leverage and futures contracts.

The third part of the Commission's legislative package presents our recommendations on the activities of the National Futures Association. As you know, the Commission submitted its report on the regulatory performance of the NFA to Congress on January 1, 1985. The Commission generally concluded that NFA has succeeded in meeting its mandate to adopt and, with certain exceptions, to implement a comprehensive self-regulatory program in the public interest. Our recommendations with respect to NFA came out of this report. They should enhance both NFA's effectiveness as a self-regulatory organization and the Commission's ability to fulfill its oversight responsibilities.

First, the Commission proposes to amend section 17(h) to make the automatic stay provisions of that section inapplicable to NFA disciplinary actions, including member responsibility actions. The effectiveness of any sanctions imposed as a result of formal NFA disciplinary procedures are likely to be diminished if a suspended or expelled member can forestall the result merely by filing an appeal with the Commission. This amendment would make the stay provisions of NFA's member responsibility actions parallel those for exchange disciplinary actions.

In related matters, we propose to amend section 17(i) expressly to authorize the Commission to review only the record before NFA and the submissions of the parties. We propose to amend section 17(i)(3) to make the standards for Commission review of an NFA decision to deny membership or association with an NFA member, similar to the standards applied to NFA disciplinary actions.

Further, in order to facilitate the Commission's continuing oversight of the National Futures Association and its implementation of key self-regulatory functions, the Commission is proposing to amend section 17(k) to make the Commission's authority to alter or supplement NFA rules parallel to, and no less broad than, the Commission's comparable authority with respect to the rules of contract markets.

Another of our proposals addresses the disparity in the statutory procedures for Commission review and approval or disapproval of new rules proposed by NFA and the exchanges. Maintaining two different rule approval procedures imposes an operational and administrative burden on the Commission. We therefore propose that the NFA rule review process be made consistent with the similar provisions governing other self-regulatory organizations.

The fourth part of the Commission's legislative package proposes changes to section 9(d) of the act, which would give the Commission the authority to make appropriate changes to its standards for permissible investments by Commission personnel in recognition of the vast array of commodities on which futures contracts are now traded.

As a final proposal, the Commission seeks reauthorization for 6 years, until the fiscal year ending September 30, 1992. The Commission has been fortunate to have the active interest and ongoing oversight of this congressional committee. We welcome your continued direction and oversight until our next reauthorization.

I would be pleased to answer any questions the committee may have and, in addition, any questions that may be submitted later in writing. Since I am the first witness, other issues may come up on which the committee may wish to question the Commission.

Senator DIXON. Mr. Chairman, if I may.

Senator LUGAR. Senator Dixon.

Senator DIXON. I want to thank the Chair and my colleagues for permitting me to do this out of order. I appreciate it very much, Mr. Chairman.

Madam Chairman, I just want to say I am extremely concerned about the implications of the CFTC's suggested regulation to require 1-minute recordation of futures trading.

I believe the Chicago Board of Trade and the Chicago Mercantile Exchange when they say that bidding on their floors will be severely impaired by this proposed Commission regulation. May I say that I have been on the floor many times, and while it looks pretty frenzied out there, obviously a lot of important business takes place. Since these exchanges represent 80 percent all of futures trading in the country, in my city of Chicago, I simply cannot take the problem lightly.

I want to urge you, Madam Chairman, to try to reach an agreement with the futures exchanges on a method of obtaining an adequate audit trail. I would like to be kept abreast of the progress of the negotiations between the CFTC and the industry. And I would like to suggest, Mr. Chairman, that we have another meeting before we do the final markup on reauthorization of the agency to discuss what has been done. I want to make my position very clear, Mr. Chairman and Madam Chairman, I understand the need for the CFTC to be doing something in this area. I applaud the fact that you are looking at it. I would not want anyone to misinterpret my position.

On the other hand, this is a major industry in my State, and I must say that I have to say as a lay person, Mr. Chairman, I do not see how on the busy trading floor—many of you have been on the floor, you have seen it—how you can mark down in pencil, within a minute of every trade, what trades are taking place there. I just believe that this 1-minute rule would adversely impact the increasingly important business that takes place on the floor. I would urge these very dedicated people in the CFTC to take into account that this is a major industry in our country and we want it to prosper.

All I am saying, Madam Chairman, is I would very much like to meet with representatives of your Commission to discuss this at your convenience in my office. My colleague, Senator Simon, is like-minded. I would like, before we ultimately markup, to have some sort of report about what progress has been made toward accommodating the interests of a free enterprise system in our country, that is very important to our economy, while still doing the necessary job that I recognize the Chairman and her Commission have to do.

Senator LUGAR. Chairman Phillips, do you have at least a summary comment at this point to respond to the Senator?

Ms. PHILLIPS. Absolutely. I appreciate your concerns about this issue.

It indeed is a very important issue, and I might say first of all, that I will be delighted to come over and meet with you at your convenience to describe the progress that is being made. Let me say I think there is a lot of progress being made.

Senator DIXON. Good, and may I say that I have heard that too, Madam Chairman. None of this was intended to be critical of the outstanding work you are doing and the work of the Commission.

I just wanted to say—and I must again confess, Mr. Chairman, I am a lay person—but I am told by the industry that there are electronic methods—and frankly I cannot run a computer, I know many in the room can—that would address this problem. I just feel very sincerely that having seen this operation—as I say, it looked so frenzied in there—but they are doing a lot of business. You just cannot stop and jot down things with a pencil while you are making these major trades.

And, of course, errors are the responsibility of the traders. There are a variety of reasons why I think this is very, very important.

I want to thank you, Mr. Chairman, and my colleagues for letting me address the Chairperson like this, and ask her to cooperate with us in the way that she carries out her functions while protecting the important free enterprise system in the country.

Ms. PHILLIPS. I look forward to meeting with you.

Senator DIXON. Thank you, Mr. Chairman.

Senator LUGAR. Thank you.

Let me just follow through for a moment.

This is obviously an issue or some importance. Can you give us any idea how some reconciliation of viewpoints might be possible? Can you sketch out some parameters of where you are headed with this?

Ms. PHILLIPS. As you may know, the Commission finalized its rules in January. We have asked the exchanges to develop the way they will come into compliance, and asked them to submit this description in July. So there is a lot of pushing and hauling that is going on right now because this, in fact, is the period in which the exchanges are developing their systems.

Several of the large exchanges have come up with a completely new approach and, in fact, I and senior Commission staff went out and met with the exchanges and then their staffs came to Washington for meetings. So we are in the midst of ongoing discussions.

I think that the proposals they are working on at this point are really still in the concept stage. They really have not been fully fleshed out. We believe that they have a good deal of potential and would like to see them developed more fully, to present the empirical data that are necessary, or even the theoretical development of them, so that we can be assured that, in fact, their systems will produce an adequate audit trail that includes all traders.

Senator DIXON. If I may interrupt. I want to thank you for those comments. That is the thing that pleases me greatly.

May I suggest that I think it is implicit in your statement that we might be giving an opportunity for the exchanges to develop a pilot program that you could review to see whether it is adequate to satisfy the audit trail requirements that you are suggesting.

If something like that could be done, I would think that would be worthwhile.

Thank you.

Ms. PHILLIPS. We would anticipate that there would have to be a fair amount of testing of it. We could anticipate that the exchanges may want to phase in, particularly the very large exchanges may want to phase in various aspects of it. So we do not see this as a short-term project. It is a major and important endeavor with respect to both customer protection issues and, of course, market integrity issues.

Senator DIXON. Yes; I want to leave you with the thought that we want to protect the integrity of the marketplace. That it is important for the industry to flourish. That it is quite obviously important to protect the consumer. I will appreciate very much receiving further information from you and suggestions about the progress you are making.

Ms. PHILLIPS. We will be delighted to submit it, both to you and for the record.[1]

Senator HEFLIN. Mr. Chairman.

Senator LUGAR. Senator Heflin.

Senator HEFLIN. Since we are on that subject, that is one of the areas that I am interested in too. I would like to sort of echo what Senator Dixon has said here and hopefully that it can be worked out.

It seems to me that in modern times as we are living and so forth, these things can be worked out. I have seen people approach it with the viewpoint of trying to bend a little bit on both sides.

Ms. PHILLIPS. We certainly indicated that we are willing to work with the exchanges because this is an important issue, not only for the exchanges, but for regulatory oversight.

Senator LUGAR. Madam Chairman, just to complete our record at this point, would you describe why the audit trail that you have sought is important for enforcement and why each minute of time is a requirement as opposed to longer gaps in the trail?

Ms. PHILLIPS. As you probably know, Senator, this issue has been around for quite awhile. The last time it was looked at by the Commission was in the mid to late seventies and, of course, computer technology was not as far along at that time. In addition, the Commission has engaged in several studies, some of them at the insistence of the Congress. For example, the study that we submitted to you a year or so ago on the use of nonpublic material information.

One of the things that that report identified was concern with the practice known as dual trading, potential abuses with respect to trading ahead of the customer. So, in order to find out whether a broker is trading ahead of his customer, you need to know the order in which trades occur.

The other areas or reasons that led us to an improved audit trail had to do with a number of market studies in which we engaged. As you know, in the summer of 1983, the grain market in particular was very volatile. In the fall of 1983, there were a number of allegations that were made with respect to particular grain markets. We were asked to review those markets and determine whether or not there had been manipulation in those markets. There were concerns expressed about what was happening in the last half hour of trading, what was happening in the last 15 minutes. Were certain traders exceeding speculative limits during the day?

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[1] See p. 190 for additional information from Ms. Phillips.

Now, we did complete the study and were able to conclude that there was no manipulation. But I will have to say quite frankly there were some questions we could not answer with respect to intraday activity.

So, it is really not one thing that led us to feel the need for the audit trail; it is a number of things. It was enforcement actions, for example, that we could not pursue. We looked into exchange files, and they were not able to pursue certain kinds of actions. The bracket information that is currently available is inaccurate and leaves such wide gaps that you really cannot on occasion reconstruct trading.

So, for those reasons, not any one of which, I think, was dispositive, but for all of those reasons, the Commission ultimately decided that this was the time and that technology, not just technology with respect to traders reporting the information themselves, but the backup computer systems that will handle all of that data were available. If you get it, handle it, massage it, produce surveillance audit trails so that we can find out what is going on in those markets at precise periods of time. So, if questions are raised, we can look quickly and respond to concerns that are raised. I think that this has very serious implications with respect to the confidence in the market as to how quickly we are able to respond.

Senator LUGAR. I thank you. I just make the point that Senator Dixon already made so well that this subcommittee in its oversight is, of course, deeply concerned about your having enforcement powers that are adequate in the public's interest. The industry has likewise expressed their desire for that to be the case.

This is a growth industry, a remarkable market situation that we just dare not let get out of hand in any way with regard to public confidence on the part of operations.

We appreciate your stewardship and that of your Commission and the industry that works with you.

Senator Zorinsky, do you have questions for Chairman Phillips?

Senator ZORINSKY. Madame Chairman, the audit trail question has generated a lot of interest. In that connection I would be curious to know whether you can estimate the degree to which there may be fraudulent activities involved in trading on the exchanges?

Ms. PHILLIPS. Well, in terms of percentage of activity that goes on?

Senator ZORINSKY. Yes.

Ms. PHILLIPS. No, not really. As a matter of fact, I do believe and am quite confident that most of the activity that occurs on those exchanges is done without that kind of association.

Senator ZORINSKY. How would it compare, for instance, with embezzlement in a bank?

Ms. PHILLIPS. Well, I guess fraud is fraud. I mean if it is in a bank or on an exchange.

In terms of how often does it occur?

Senator ZORINSKY. Yes.

Ms. PHILLIPS. I guess I have absolutely no idea.

Senator ZORINSKY. I would echo the sentiments that some of my colleagues have already expressed concerning the audit trail question. In addition, I think we have to be practical from the point of view that we not destroy the industry we are attempting to supervise. From that standpoint, I would appreciate some comity in this area so that a solution can be negotiated that not only meets your needs but also the needs of the industry itself to perform and operate in a manner that expedites their efficiencies.

Ms. **Phillips**. I believe our goals are similar. I think both the exchanges and we want to have improved audit trails. The question is how to get there, and that is the process that we are engaged in now. Might I say I think it is a very healthy process, and welcome the dialog with the exchanges.

I committed to Senator Dixon, and I will be glad to submit for the record, a report that we would make to him.

Senator **Zorinsky**. Thank you, Mr. Chairman.

Senator **Lugar**. Thank you, Senator Zorinsky.

Senator Melcher.

Senator **Melcher**. Thank you, Mr. Chairman.

Chairman Phillips, in the area of appellate review you want to eliminate the two-step procedure and go directly from the Commission to the appellate court.

Currently if somebody appeals a ruling of the Commission they go to a Federal district court. Do they go on the record or is it de novo?

Ms. **Phillips**. Well, there are some sections of our act that do specify going to the court of appeals already. So, in some instances, you would go to the court of appeals.

For those sections on which the act is silent, they would go to district court and a record can be generated at that point.

Senator **Melcher**. A new record?

Ms. **Phillips**. Yes.

Senator **Melcher**. Additional information may be provided?

Ms. **Phillips**. Yes, sir. Additional information could be——

Senator **Melcher**. When they go to the appellate court, they go on the record, do they not?

Ms. **Phillips**. Yes; that is correct. They go on the record. If an inadequate record has been developed, the judge can, of course, remand it to the Commission for further development.

Senator **Melcher**. Is that done?

Ms. **Phillips**. It has been done, yes, sir.

Senator **Melcher**. You do not feel that those who appeal the Commission's ruling are going to be restricted in any of their rights that now exist, if you make this modification in the statute?

Ms. **Phillips**. We do not believe so.

Senator **Melcher**. If I understand your testimony correctly, you are recommending that you would not have jurisdiction over leverage?

Ms. **Phillips**. Actually we would recommend that the exclusive jurisdiction that we now have be deleted from the act. That would mean to the extent that those firms alter their businesses to come into conformity with State regulations, they would then be under State jurisdiction.

Senator **Melcher**. They operate nationally?

Ms. **Phillips**. Yes, they do.

Senator **Melcher**. And that is part of the game, to operate nationally?

Ms. PHILLIPS. I am sure that that would be their business goal, certainly.

Senator MELCHER. Then they have no regulation nor does the State have regulation?

Ms. PHILLIPS. That would be correct—other than any kind of State banking regulations or Federal or State securities regulations, for example, that might apply with respect to their issuance of securities.

Senator MELCHER. Perhaps I am missing part of this.

Is it customary, for instance, that if the leverage concern does not sell anything in Montana, but it sells to many other States, that they would be regulated by whichever State they sold in?

Ms. PHILLIPS. Could be.

Senator MELCHER. Is that the case?

Ms. PHILLIPS. They are not now. Now, of course, they must be registered and regulated by us.

Senator MELCHER. Does it actually prevent States from regulating?

Ms. PHILLIPS. Yes; we have exclusive jurisdiction over them now.

Senator MELCHER. Well, is there not some interplay here, if some people invest in leverage and others invest in futures contracts?

Ms. PHILLIPS. Well, I think what we would envision is that these firms go more toward an installment kind of operation, or cash and carry. So that they would be just like any other commercial enterprise and would be subject to the commercial laws of individual States in which they operate.

Senator MELCHER. Would the effect be leaving a leverage operation with no uniform type of regulation, no possibility in developing a uniform type of regulation?

Ms. PHILLIPS. Well, we have been working with NASAA, the North American Securities Administrators Association, and they have developed a model State code which would govern the enforcement and regulation of commodity transactions. Some States have passed it. It is now being considered by other States.

So, in that sense, there could be coordination among States. But, no, it would be more like any other commercial transaction.

Senator MELCHER. How much is invested in leverage transactions?

Ms. PHILLIPS. I am sorry, I do not know that. I could give you an idea as to the approximate number of customers some of the large firms have.

Senator MELCHER. Could you round it off in hundreds of millions or billions?

Ms. PHILLIPS. I am sorry, I cannot. I will be glad to submit that for the record if you would like.

Senator MELCHER. Would it be fair to believe that it is in the billions?

Ms. PHILLIPS. Just a second. Let me see if any of my staff know.

As I understand it, one of the major firms is in the vicinity of about half a billion dollars.

Senator MELCHER. One?

Ms. PHILLIPS. One firm.

Senator MELCHER. One of the major firms, and there are other major firms?

Ms. PHILLIPS. There are two firms, two such firms, yes.

Senator MELCHER. Has it been your thought that the Commission has had any effect on leverage transactions?

Ms. PHILLIPS. We have put into place a comprehensive leverage regulatory structure. It has been a fairly time consuming operation for both the Commission and the firms, I believe.

Part of the reason that we have come to the conclusion that we believe that it is inappropriate for the Federal Government to regulate this kind of activity is it is very resource intensive. We believe it is best done at the individual State level. I think we are all looking for ways to try and streamline and trim our Federal Government operations.

Senator MELCHER. Your testimony is to the effect—and I ask you this directly because I want to know—is to the effect that, first of all, you do not believe the CFTC should regulate leverage transactions. That is correct, is it not?

Ms. PHILLIPS. That is correct.

Senator MELCHER. Second, that it should be regulated by Federal law?

Ms. PHILLIPS. That is correct.

Senator MELCHER. Now, on to the audit trail.

First of all, if I called some broker to place an order for me, they would punch it in right then on their computer, and you would have an audit trail beginning?

Ms. PHILLIPS. That would certainly depend on the firm to which you called. Some are more computerized than others.

Senator MELCHER. All right.

Let me take it to the point where that firm takes my order to the exchange. It would be punched in, even though I am in a remote place. It would be triggered just on that telephone call.

Ms. PHILLIPS. Firms are required to keep records of the timing of orders, customer orders.

Senator MELCHER. When does that record start?

Ms. PHILLIPS. At the time the order is received.

I am sorry. I misunderstood your question.

No; certainly they are required to keep records. Whether or not they keep it in a computer form or whether they keep it in a hand form depends on the degree to which the individual firm is mechanized.

Senator MELCHER. The time it is punched in or noted?

Ms. PHILLIPS. It is noted, yes.

Senator MELCHER. And that is what you can review?

Ms. PHILLIPS. Yes, among other kinds of records.

Senator MELCHER. All right.

They then place the order with the exchange?

Ms. PHILLIPS. Yes; then they must call it in to the exchange.

Senator MELCHER. What do you require at that point?

Ms. PHILLIPS. There is an entry time, yes, at the exchange.

Senator MELCHER. Which you can review?

Ms. PHILLIPS. Yes.

Senator MELCHER. So I am protected as an investor by the mechanism that now is in place.

Ms. PHILLIPS. You are protected——

Senator MELCHER. Up to that point?

Ms. PHILLIPS. Up to that point, that is correct.

Senator MELCHER. All right.

Taking the audit trail beyond that point right into the pit, what are you suggesting, that the mechanism be for the time of the sale or the purchase?

Ms. PHILLIPS. We are asking that the time of execution be recorded on the trade register within 1-minute time increments so it does not say that individual brokers executing in the pit must record them. But in some way that time must be captured. It could be recorded, again by an electronic mechanism; it could be recorded manually, or it could be captured separately which is one of the ways that some of the large exchanges are proposing.

Senator MELCHER. My order is in the pit, either buy or sell, and whoever is doing it makes the transaction and gives a notification to a runner who takes it to somebody who records that transaction right in the pit?

Ms. PHILLIPS. Who makes the trade.

Senator MELCHER. Yes.

Ms. PHILLIPS. Yes, would make the trade, yes.

Senator MELCHER. That is how it is done now?

Ms. PHILLIPS. Yes.

Senator MELCHER. It is done in 30-minute increments, is it not?

Ms. PHILLIPS. The brokers are required now to record the brackets, yes, the 30-minute bracket period within which the trade occurred.

Senator MELCHER. You are going to be checking two sides of the trade. As it stands right now, you have already 30 minutes. It is very likely that the person on both sides of the trade are going to be recorded in that same 30-minute period, are they not?

Ms. PHILLIPS. Generally, yes, unless you are at the front end or the back end of the bracket.

Senator MELCHER. How could you be assured that the runners from the person to the pit recording device get there in 1 minute? Is it physically possible?

Ms. PHILLIPS. Both sides would—if you had a manual recordation system, which I think is what you are describing, they may——

Senator MELCHER. I am not describing what the traders do. I am describing when the traders give the notification, that is the sale or the purchase, to a runner who then takes it to a recording device located in the pit.

Ms. PHILLIPS. The recording device that is located outside of the pits for each of the individual booths. There is no time recordation in the pit at the current time.

Senator MELCHER. But they do have to give the sale or the purchase to the runner?

Ms. PHILLIPS. Or flash it out of the pit, yes.

Senator MELCHER. To whom?

Ms. PHILLIPS. To the order desk or the booth at the edge of the pit.

Senator MELCHER. Then you would compare those times to make sure that that was a valid transaction?

Ms. PHILLIPS. We are not requiring that those times match in order for——

Senator MELCHER. There is no requirement for that?

Ms. PHILLIPS. No.

Senator MELCHER. Are you going to require it be accomplished within 1 minute?

Ms. PHILLIPS. No.

Senator MELCHER. You are not.

Have you decided what you are going to require?

Ms. PHILLIPS. What we are asking is that transactions be recorded on the trade register and that they be timed in 1-minute increments. There is not a clearing criterion for them, but those times must be recorded so that we could then be able to reconstruct trades.

Now, to the extent that they do not match, there would be a capability to move either back or forward a few minutes.

For example, the Kansas City Board of Trade has such a system, and they move forward or back in order to be able to match those kinds of trades. So——

Senator MELCHER. You are going to require the person in the pit who makes the trade to put down the minute?

Ms. PHILLIPS. No, we are not. You could. I mean that is one way it could be done. But we are not requiring that.

Senator MELCHER. Could you supply to the committee just what you are going to require?

Furthermore, would you show in that description in an easily understood manner how this varies with what the studies of either the board of trade or the Commodities Exchange produced in their studies for recommendations?

Ms. PHILLIPS. I would be glad to supply that information to the committee.

Let me again emphasize that this is a rulemaking that is in process, and so much depends on how the exchanges implement their own systems. But I will be glad to supply the information we have received to date.

Senator MELCHER. This is the time for reauthorization of the act. However, I do not believe you are asking any amendments to the statute that involves this particular audit trail?

Ms. PHILLIPS. That is correct.

Senator MELCHER. You have sufficient statutory authority.

Since this is the time when this committee deals with the subject matter under your direction, and the reauthorization is before us, it is a time when I want to understand thoroughly that what you are proposing will be workable and can be accomplished. I am a little bit concerned when you talk about a 1-minute audit trail. That is your phrase. I want to be sure that it is not a nightmare of pencil notations that will not contribute to protection to myself or anybody else that might want to invest in futures trading. One minute scares me to be honest with you.

Ms. PHILLIPS. Certainly the goal is to get an audit trail. And because of the activity, in fact, in the pit, 1 minute is what we believe to be a prudent compromise to accomplish an audit trail. In fact allowing that kind of leeway, there may be transgressions that could occur within 1 minute. And we recognize that. But we believe that timing within 1 minute will provide us with enough information so that a properly developed audit trail for all traders could be accomplished. So——

Senator MELCHER. Let me interject here one concern of mine.

Assume someone is trying to rig a deal that could be rigged between two traders. I do not know whether we can do anything about it except to allow the two traders to demonstrate by arranging what that particular 1 minute is going to be, either prior to or after the transaction. Certainly I am interested and the whole committee is interested in whatever the audit trail is because that is what you are supposed to be doing to prevent rigging, in order to prevent fraud and protect the investors.

I think the exchanges are very much interested in that because the future of their futures dealings depends upon the confidence of the investor. I thoroughly understand how we all have a common interest and want a common law. Of course, the question is will it work and what can we do to make it work. If you can show me your thoughts in terms so that I can understand just what you are proposing to do, and show me where this incorporates the recommendations of the exchanges which are vitally interested in this matter for their own reasons, I would very much appreciate it and I would like to thoroughly understand this prior to taking final action on this reauthorization bill.

Ms. PHILLIPS. Again we will be glad to submit a report to the committee. I think that—from what I can gather, there is a full understanding of the need for an audit trail in order to be able to bring actions that are violative of the act.

Senator MELCHER. Thank you, Madam Chairman.

Ms. PHILLIPS. Thank you.

Senator LUGAR. Thank you very much, Senator Melcher.

Senator ZORINSKY. Mr. Chairman.

Senator LUGAR. Senator Zorinsky.

Senator ZORINSKY. I hope we are not embarking on an attempt to legislate morality because you cannot legislate morality. It is up to the individuals, management, and the industry itself to gain credibility so that people will have faith, trust, and confidence in that institution.

I believe that you have some good thoughts and certainly there should be a protection for the people using the system. Yet, the other side of that coin is that we not attempt to legislate morality within the futures trading industry to such an extent that we completely destroy the industry.

Ms. PHILLIPS. I could not agree with you more, Senator. I think in fact that the existence of an audit trail will allow people to participate in that system and know that if they have a disagreement with a broker, they have a basis on which to settle those kinds of disagreements.

So, in fact, it is a two-way street in that sense, that it will allow not only the exchanges and the Commission to be able to bring appropriate cases where we need to, but it will also be able to allow the disproof if there are unfair allegations made against the exchanges with respect to manipulation, trading ahead of customers, or wash trading that some people on occasion accuse traders of engaging in.

So, it will have the effect also of being able to disprove, and disprove quickly, which I believe will be helpful to the growth and the confidence in the market.

Senator **Zorinsky**. Thank you.

Senator **Lugar**. Thank you, Senator Zorinsky.

Thank you, Madam Chairman. We appreciate your appearance.

Ms. **Phillips**. Thank you very much, and we look forward to working with you and the committee as we proceed in this endeavor.

[Questions submitted by Senator Helms to Chairman Phillips and answers thereto:]

LEVERAGE TRANSACTIONS

The Committee is interested in comparing and contrasting futures contracts with leverage contracts. Specifically, the Committee would like to receive from the Commission, to the extent that it is available, the following information:

Question (1)(A). An investor profile of the characteristics of purchasers of futures contracts compared with investors in leverage contracts.

Answer. Limited information is available on the characteristics of purchasers of leverage instruments and futures contracts. However, reports received by the Commission indicate that members of the general public are the main customers of leverage transaction merchants (LTMs). In this regard, the two major leverage "LTMs" began reporting to the Commission on the extent of commercial participation in leverage contracts in June 1984. These reports indicate that there have been no commercial leverage accounts in the period June 1984–January 1985. Futures markets, in contrast, are used by commercial firms for hedging or price basing, and the Commission publishes monthly statistics indicating the commercial participants in most futures contracts.

The recent Congressionally mandated interagency study of futures and option markets, "A Study of Effects on the Economy of Trading in Futures and Options," provides some information on the investor profile of public non-commercial traders in futures markets. A limited number of markets were surveyed including stock index, Treasury bond and corn futures markets. Most of the respondents from the equity-related and Treasury bond futures markets were well educated, well capitalized and had high income. About 90% had attended college and nearly 40% had received graduate or professional degrees. In addition, the majority had "investment net worth" (i.e., excluding personal residence and property) exceeding $100,000 and pre-tax household incomes greater than $50,000 per year. (p. V-4) More than 90% of the respondents traded stocks and bonds prior to trading stock index futures. (p. V-5)

Public noncommercial traders in the corn futures market differed somewhat from their counterparts in the financial futures markets. They had lower household incomes (45% earned less than $50,000 a year as compared to about 30% of financial futures respondents) and had achieved a different education level (only 62% had attended college as compared with approximately 90% of the financial futures respondents). Public corn futures traders' net worth, however, was similar to public financial futures traders' net worth (65% of the corn futures respondents had "investment net worth" in excess of $100,000). (p. V-15) Corn futures respondents also had less experience trading stocks and bonds and other futures contracts. (p. V-16)

In contrast, the Commission is not aware of any comparable investor profiles for leverage customers. However, if customers filing reparation complaints against leverage merchants could be viewed as representative, it would appear to indicate that customers who are sold leverage contracts tend to be less sophisticated and less financially secure than the above profile of futures customers.

Question (1)(B). An investment comparison providing data on the dollar value, duration of and return on futures versus leverage transactions.

Answer. Limited information is available on the dollar value, duration of and return on futures versus leverage transactions. With regard to the dollar value of leverage versus futures contracts, leverage contracts tend to be the same size or smaller than comparable futures contracts. For example, Monex, IPMC, the Chicago Board of Trade and MidAmerica Commodity Exchange all offer 1,000 ounce silver bullion contracts. IPMC also offers a 500 ounce silver bullion contract. The higher commission and other transaction costs usually associated with leverage contracts, however, often cause the return required to break-even on a leverage contract to exceed the return required to break-even on a futures contract for the same commodity. The Commission's staff prepared an analysis of customer transaction costs as an attachment to a letter to Senator Richard G. Lugar dated July 23, 1984. In this analysis, (based on an assumed one-year holding period for all contracts) it was found that the price of a silver futures contract would have to increase approximately 14% before a customer could profit from the transaction, while the bid price of the Monex and IPMC leverage contracts would have to rise by 17% and 21% respectively.

An amendment to the Commission's leverage regulations, however, provided for increased information on leverage trading. Briefly, rule 31.26 requires LTMs to file quarterly reports containing information on every leverage contract closed out during the quarter. The required information includes the profit or loss associated with each transaction, the actual duration of the transaction and the initial and repurchase or resale contract prices. LTMs were originally required to file these quarterly reports beginning January 1986. The two registered LTMs petitioned and were granted extensions of time until July 1986 because of computer programming problems.

Question (1)(C). A customer complaint history on the type and quantity of complaints filed by purchasers of futures contracts versus leverage contracts. Because many exchanges have their own arbitration procedure and the NFA has its own dispute settlement process, if possible, the Commission's response should include those totals also, in order to provide a full complaint history. Also, the Commission's response should note any significant developments, such as the promulgation of regulations concerning leverage transactions, that might have an influence on the complaint totals.

Answer. Attached is an analysis which shows the number of complaints filed against leverage firms versus complaints filed against other firms between October 1, 1982, and January 1, 1986. While the Commission does not keep records on the type of complaints filed, it is fair to say that most futures and leverage complaints involve misrepresentation, failure to disclose risks, churning, or unauthorized trading. During this period, there were 247 complaints filed involving leverage instruments and 1,794 complaints involving futures contracts.

The attached statistical analysis of complaints filed between October 1, 1982, and January 1, 1986, provides some basis for comparing the complaints against leverage firms with those of all other firms. However, it is important to note two factors. First, since reparation complaints may be filed anytime within 2 years after the time the cause of action occurred, these tables do not reflect the extent to which the Commission's new leverage regulations, which went into effect April 13, 1984, may have affected customer complaints. And second, the tables show statistics for four firms: (1) First National Monetary Corporation ("FNMC"), (2) International Precious Metals Corporation ("IPMC"), (3) Premex and (4) Monex. Only Monex and IPMC are registered with the Commission as LTMs. Premex is no longer in business as the result of a Commission enforcement action. FNMC has not applied for registration as an LTM.

NFA, which began its program in March 1983, has received the following number of arbitration demands, which includes complaints by customers against NFA members as well as member-to-member complaints. None of the leverage firms are members of NFA although some have affiliated firms dealing in futures contracts which are members of NFA.

NFA Arbitration Demands

March–September 1983	38
Fiscal year 1984	80
Fiscal year 1985	201
October 1, 1985–February 14, 1986	98
Total	417

Available exchange arbitration statistics are attached. None of the leverage firms are members of exchanges.

Attachment.

SUMMARY OF LEVERAGE AND FUTURES COMPLAINTS FILED AND FORWARDED FOR ADJUDICATION FROM OCTOBER 1, 1985 to JANUARY 1, 1986

FISCAL YEAR	LEVERAGE COMPLAINTS FILED	FUTURES COMPLAINTS FILED	TOTAL COMPLAINTS FILED
1986	5	86	91

FISCAL YEAR	LEVERAGE COMPLAINTS FORWARDED	FUTURES COMPLAINTS FORWARDED	TOTAL COMPLAINTS FORWARDED
1986	3	69	72

Total Number of Leverage Complaints Filed and Forwarded for Adjudication During Fiscal Year '86 -	FILED 1/	FORWARDED FOR ADJUDICATION 2/
	5	0
First National Monetary Corporation -	2	0 3/
International Precious Metals Corporation -	0	2
Monex -	3	1

1/	CASES FILED -	Reparation cases that have been filed with the Complaints Unit and assigned a docket number.
2/	FORWARDED FOR - ADJUDICATION	Filed reparation cases that have been sent by the Complaints Unit to the Proceedings Clerk for assignment to an adjudicator.

3/ FNMC has not applied for registration with the Commission as a LTM under the new leverage regulations but is registered as a CTA.

SUMMARY OF LEVERAGE AND FUTURES COMPLAINTS FILED AND FORWARDED FOR ADJUDICATION DURING FISCAL YEAR 1985

FISCAL YEAR	LEVERAGE COMPLAINTS FILED	FUTURES COMPLAINTS FILED	TOTAL COMPLAINTS FILED
1985	47	407	454

FISCAL YEAR	LEVERAGE COMPLAINTS FORWARDED	FUTURES COMPLAINTS FORWARDED	TOTAL COMPLAINTS FORWARDED
1985	30	384	414

Total Number of Leverage Complaints Filed and Forwarded for Adjudication During Fiscal Year '85 -	FILED 1/	FORWARDED FOR ADJUDICATION 2/
	47	30
First National Monetary Corporation -	25	14 3/
International Precious Metals Corporation -	12	9
Monex -	10	7

1/	CASES FILED -	Reparation cases that have been filed with the Complaints Unit and assigned a docket number.
2/	FORWARDED FOR - ADJUDICATION	Filed reparation cases that have been sent by the Complaints Unit to the Proceedings Clerk for assignment to an adjudicator.

3/ FNMC has not applied for registration with the Commission as a LTM under the new leverage regulations but is registered as a CTA.

SUMMARY OF LEVERAGE AND FUTURES COMPLAINTS FILED AND FORWARDED FOR ADJUDICATION DURING FISCAL YEAR 1984

FISCAL YEAR	LEVERAGE COMPLAINTS FILED	FUTURES COMPLAINTS FILED	TOTAL COMPLAINTS FILED
1984	56	466	522

FISCAL YEAR	LEVERAGE COMPLAINTS FORWARDED	FUTURES COMPLAINTS FORWARDED	TOTAL COMPLAINTS FORWARDED
1984	31	255	286

Total Number of Leverage Complaints Filed and Forwarded for Adjudication During Fiscal Year '84 -	FILED 1/	FORWARDED FOR ADJUDICATION 2/
	56	31
First National Monetary Corporation -	23	14 3/
International Precious Metals Corporation	7	5
Premex -	13	1 4/
Monex -	13	11

1/ CASES FILED - Reparation cases that have been filed with the Complaints Unit and assigned a docket number.

2/ FORWARDED FOR ADJUDICATION - Filed reparation cases that have been sent by the Complaints Unit to the Proceedings Clerk for assignment to an adjudicator.

3/ FNMC has not applied for registration with the Commission as a LTM under the new leverage regulations but is registered as a CTA.

4/ Premex is no longer in business as the result of a Commission enforcement action.

SUMMARY OF LEVERAGE AND FUTURES COMPLAINTS FILED AND FORWARDED FOR ADJUDICATION DURING FISCAL YEAR 1983

FISCAL YEAR	LEVERAGE COMPLAINTS FILED	FUTURES COMPLAINTS FILED	TOTAL COMPLAINTS FILED
1983	95	821	916

FISCAL YEAR	LEVERAGE COMPLAINTS FORWARDED	FUTURES COMPLAINTS FORWARDED	TOTAL COMPLAINTS FORWARDED
1983	70	540	610

Total Number of Leverage Complaints Filed and Forwarded for Adjudication During Fiscal Year '83 -	FILED 1/	FORWARDED FOR ADJUDICATION 2/
	95	70
First National Monetary Corporation -	50	35
International Precious Metals Corporation -	18	14
Premex -	15	11
Monex -	12	10

1/ CASES FILED - Reparation cases that have been filed with the Complaints Unit and assigned a docket number.

2/ FORWARDED FOR ADJUDICATION - Filed Reparation cases that have been sent by the Complaints Unit to the Proceedings Clerk for assignment to an adjudicator.

	Number of Arbitrations Conducted in 1983 1/			Dollar Amount Awarded		
Exchange/Organization	Customer to Member	Member to Member	Total	Customer to Member	Member to Member	Total
MidAmercia Commodity Exchange	----	6	6	----	$14,738.13	$14,738.13
Chicago Rice & Cotton Exchange	----	----	----	----	----	----
Coffee, Sugar & Cocoa Exchange	----	1	1	----	15,460.00	15,460.00
Chicago Mercantile Exchange	18	33	51	72,240.00	79,394.00	154,634.00
Kansas City Board of Trade	----	----	1	----	----	14,161.35
Minneapolis Grain Exchange	1	2	3 2/	----	----	169,482.00
New York Futures Exchange	----	4	4	----	8,200.00	8,200.00
New York Cotton Exchange	----	----	4	----	----	23,000.00
Commodity Exchange, Inc.	14	9	23	8,250.00	194,911.00	203,161.00
New York Mercantile Exchange	1	3	4	----	----	13,000.00
Chicago Board of Trade	12	36	48	----	----	124,568.19
National Futures Association *	----	----	45	----	----	17,671.96
New York Stock Exchange	----	----	713	-	----	---- 3/

1/ Figures were provided by each exchange or organization and include all matters submitted for arbitration to each forum (not necessarily the number concluded).

2/ The four arbitrations conducted involved cash trading as opposed to futures transactions.

3/ The NYSE does not keep this figure at all.

* NFA's arbitration program began on March 31, 1983.

Number of Arbitrations Conducted in 1984 1/				Dollar Amount Awarded		
Exchange/Organization	Customer-to-Member	Member-to-Member	Total	Customer-to-Member	Member-to-Member	Total
NYCE	0	1	1	0	0	0
CME 4/	10	76	86	$82,880.00	$329,499.00	$412,[illegible].00
COMEX	6	4	10	3,809.20	15,461.00	19,270.20
NYFE	0	4	4	0	0	0
MGE	0	0	0	0	0	0
MACE 4/	0	9	9	0	5,594.00	5,594.00
CRCE	0	0	0	0	0	0
KCBT 4/	0	0	0	0	0	0
CBT	16	23	39	39,281.60	92,131.88	131,413.48
CSC	0	3	3	0	27,876.84	27,876.84
NFA	26	0	26	25,907.45	0	25,907.45
1984 Sub-total	58	120	178	$201,878.25	$470,562.72	$672,440.97
NYSE	259	101	360	n/a	n/a	n/a
Number of Arbitrations Conducted in 1985 1/				Dollar Amount Awarded		
NYCE	0	0	0	0	0	0
CME 4/	12 2/	36 3/	48	0	$635,995.00	$635,995.00
COMEX	2	3	5	$24,755.34	301.00	25,056.34
NYFE	0	3	3	0	0	0
MGE	0	0	0	0	0	0
MACE 4/	0	0	0	0	0	0
CRCE	0	0	0	0	0	0
KCBT 4/	0	0	0	0	0	0
CBT	6 5/	19	25	58,510.41 5/	323,523.44	
CSC	2	4	6	2,100.00	61,619.50	63,769.50
NFA	41	0	41	157,388.38	0	159,388.38
1985 Sub-total	63	65	128	$244,754.23	$1,207,732.66	$1,776,010.33
NYSE	n/a	n/a	640	n/a	n/a	n/a
TOTAL 6/	121	185	306	$446,632.48	$1,678,295.38	$2,448,451.30

1/ Figures were provided by each exchange or organization. Figures for 1985, unless noted, are for time period January 1, 1985 through August 28, 1985.

2/ Figures cover time period 1/1/85 - 7/25/85.

3/ Figures cover time period 1/1/85 - 7/24/85.

4/ No claims involved Geldermann, Inc.

5/ One arbitration involving Geldermann, resulting in award of $54,718.54 to FSI.

6/ Commodities SROs only (excludes NYSE).

n/a Information not available.

Question (1)(D). A consumer protection summary which catalogues the protections afforded under CFTC regulations to purchasers of futures contracts and of leverage contracts.

Answer. The Commission has not had occasion to prepare a comparison of the customer protections afforded under its regulations to purchasers of futures contracts and of leverage contracts. However, in 1982, in connection with the Vice President's Task Group on Regulation of Financial Services, the Commission did prepare a chart comparing the principal aspects of the regulation of futures and options by the Commission and of securities options by the Securities and Exchange Commission (Attachment A). In addition, in connection with its review of existing dealer options regulations in 1984, the Commission prepared a chart comparing the regulations governing dealer options with the regulatory schemes governing leverage transactions and governing exchange-traded options (Attachment B). Although some amendments to the Commission's regulations in these areas have been made since the charts were prepared, the thrust of the regulatory programs remains the same.

[ATTACHMENT A]

DUPLICATION AND DIFFERENTIAL TREATMENT SUBCOMMITTEE
AGENCY: CFTC

REGULATION OF SECURITIES OPTIONS	REGULATION OF FUTURES AND OPTIONS ON FUTURES
A. Threshold Costs	
(Margin)	
1. Authority	
The Federal Reserve Board and SEC have pervasive authority to establish and enforce margin standards for securities and securities options. For options on debt instruments, foreign currencies and stock indices, the amount of initial margin is set by the options exchanges, subject to regulatory approval, as is the case with options on futures traded on contract markets. (The Federal Reserve Board is currently examining the issue of Federal government authority over margins in the securities and commodities industries. 47 Fed. Reg. 47464 (October 26, 1982)).	Section 8a(9) of the Commodity Exchange Act, 7 U.S.C. §12a(9), authorizes the CFTC to set levels of margin in times of emergency, a power which has been exercised in the past, and Section 4c(b), 7 U.S.C. §6c(b), confers plenary authority on the CFTC to regulate option transactions, including margin thereon. (The CFTC is not authorized to fix the futures margin requirements of the contract markets under normal market conditions.) For options on futures, the CFTC has adopted rules setting forth certain margin requirements (e.g., each contract market or its clearing organization, as applicable, must have in place a system to require the payment of margin by option grantors and, where applicable, their FCMs); and giving it the authority to review contract market rules relating to the system of the payment and collection of option premiums and margin. Thus, the CFTC has prohibited the margining of option premiums. Finally, under Section 5a(8), 7 U.S.C. §7a(8), contract markets are required to enforce their rules, including established margin requirements. Margins in futures and securities serve vastly different purposes. Futures margin is akin to a performance bond designed solely to ensure contract performance and thus protect the integrity of the market. By comparison, securities margin is an extension of credit used to finance the purchase and sale of securities which themselves serve as collateral. Thus, under existing regulations, a securities investor is permitted to carry an unpaid debt of 50% of the purchase price that is already due and owing.

2. Initial Margin

Purchasers of securities options must pay 100% of the premium (*i.e.*, options have no loan value in a margin account.) Uncovered writers of options on debt securities and stock indices must post margin in a manner analogous to that for sellers and purchasers of futures contracts. (The required levels of margin have been found by the staff of the Fed to be comparable to those for futures and options on futures.) For purposes of calculating a securities option market maker's net capital requirement, the SEC permits inclusion of the market value of a long option contract, minus an appropriate risk factor, as part of such a firm's current assets. *See* SEC Rule 240.15c3-1(c)(2)(x).

For futures, both purchasers and sellers are subject to the same margin requirements. They generally range from 2% to 10% of the value of the contract, with margin for hedgers and "spread" or "straddle" transactions somewhat lower than margin for speculators. Margin in futures trading relates to expected volatility. When there is little volatility less margin is necessary to protect the market from an event of default.

For options on futures, purchasers must pay 100% of the premium. Long option positions purchased by an FCM's customers have no value for the purpose of calculating the firm's net capital requirement, and an FCM must take a charge against its capital for options granted by its customers. The FCM also guarantees any loss in the account. In the case of short option positions, the rules of the contract markets, which are subject to CFTC approval, generally require margin in the amount of the value of the contract premium plus the prevailing futures margin on the underlying contract. The CFTC recently requested comment on its requirements concerning margin on futures option contracts, and in particular, comment as to whether the current margin requirements affecting floor traders who may perform certain market-making functions differ unnecessarily from the requirements pertaining to securities options market makers. 48 Fed. Reg. 10857 (March 15, 1983); 48 Fed. Reg. 16291 (April 16, 1983).

3. Maintenance Margin

Uncovered securities option positions are marked-to-the-market daily. Federal Reserve Board Regulation T provides that additional margin must be deposited with the customer's broker within seven business days.

Open futures and uncovered option positions are marked-to-the-market daily. Persons with open positions that have moved away from the market are required to post additional margin within a reasonable time which, by contract market rule, may be as short as one hour. If a customer does not do so, an FCM typically closes out the customer's account and the FCM is obliged to post the additional margin. If the margin customer does not post the margin by the next business day, in the event of a deficit, or within three days in the event of a margin deficiency which does not constitute a deficit under the CFTC's net capital rules, the FCM must put additional money in segregation and also take a capital charge, which has the effect of requiring it to set aside additional liquid assets, thereby restricting the FCM's ability to engage in other activities. Thus, an FCM has a strong incentive to ensure the creditworthiness of prospective customers.

B. Suitability

There are no SEC rules on suitability. The rules of the options exchanges, NYSE, and NASD (options SROs) prohibit member firms from recommending to any customer any option transaction unless they have reasonable grounds to believe that the entire recommended transaction is not unsuitable for the customer on the basis of information furnished after reasonable inquiry concerning the customer's investment objectives, financial situation and needs.

They also prohibit broker-dealers from recommending opening transactions unless they have a reasonable basis for believing that the customer has such knowledge and financial experience that he can be expected to be capable of evaluating, and financially can bear, the risks of the transaction.

There are no provisions in the CFTC rules governing the suitability of recommended futures transactions due to the profile of the typical futures trader and the high level of potential risk in all futures trading. Unlike securities which vary widely in risk from "blue chip" securities to "hot" issues and "penny" stocks, all futures contracts have essentially the same high level of potential risk. The high risks of futures trading, together with the need to meet promptly onerous margin requirements and possible delivery obligations, impose a de facto suitability requirement, by discouraging all but the most sophisticated and financially secure from trading in the futures markets. And, since only a small percentage of futures traders rely on broker recommendations, a formal suitability requirement would apply to relatively few traders in any case. The contract markets, of course, may prescribe such requirements for their members.

Although there also are no securities-type suitability rules governing commodity options, as noted in part D., before opening an option account the FCM has a duty to acquaint himself with the personal circumstances of an option customer to determine if further disclosures are needed for that customer to make an informed decision on whether to trade options. This duty applies even when the FCM does not make recommendations. The Commission has approved rules of the National Futures Association ("NFA") which relate to the sales practices of its members and their associated persons including equitable principles of trade. The Commission anticipates that NFA will submit to the Commission for approval additional rules in this area in connection with the implementation of its audit and compliance program.

C. Account Opening

The SEC has no account opening rules. The rules of the options SROs require that in order to engage in options trading, a customer's account must be specifically approved for options trading. Before opening the customer's account, a broker-dealer must exercise due diligence to learn the essential facts as to the customer, his investment objectives, and his financial situation. In particular, the broker-dealer must seek to obtain and verify from natural person customers 15 specific categories of information, income, net worth and investment experience. Account approval must be in writing and can only be made by a qualified branch office manager or other supervisor. Exchange rules also require separate account approval before a customer may trade debt security options (whether or not the customer's account already is approved for stock options trading).

Most brokerage firms impose stringent requirements as to net worth and other matters which are normally stricter than those for securities. For example, the account opening requirements of a major brokerage firm are a net worth of $100,000 exclusive of the customer's home and insurance, an annual income of $30,000 and an initial deposit of $10,000. This is because the very nature of futures trading creates a strong incentive for FCMs to permit only the affluent to open commodity accounts, inasmuch as if a customer fails to meet a margin call promptly, the FCM is obliged to do so. (*See* part A-3). This fact, coupled with the clear and concise risk disclosure statement which the CFTC requires FCMs to provide to prospective customers (*See* part D), has proven highly effective in discouraging all but the most sophisticated and financially secure from participating in the futures markets.

As noted above and discussed in part D., an FCM, before opening a commodity option account (which because it is a limited risk vehicle may attract customers who are less affluent and sophisticated than those which trade futures contracts), must acquaint itself with the personal circumstances of an option customer to determine if further disclosures are needed for that customer to make an informed decision on whether to trade options. This may require an inquiry by the FCM into the customer's financial condition, objectives, and sophistication. The record of any additional disclosures made and the information obtained are governed by the option sales practice rules. As such, the FCM must have written sales practice procedures and an adequate system of supervision of accounts which assures compliance with this requirement. And the sales practice audits required of the contract markets must be sufficient to verify compliance as well. (17 C.F.R. §33.4(c).)

D. Disclosure

The Federal securities laws and the option SRO rules require that option investors receive at or before the time their accounts are approved for trading, an eight-page option disclosure document which provides information similar to its commodities counterpart, but which also includes reference to the availability of disclosure documents which contain supplementary disclosure about particular option products, *e.g.*, debt, foreign currencies, stock indices. This "bifurcated" approach to options risk disclosure, which was adopted by the SEC in September 1982, thus relies principally on the delivery of concise risk disclosure documents to investors comparable to that required by the CFTC's option regulations. (The effectiveness, if not the logic, of the SEC's previous option disclosure requirements, *i.e.*, the OCC 56-page prospectus, had been questioned by the SEC's Special Study of the Options Markets which concluded that many customers did not understand it.)

The CFTC requires risk disclosure which is brief and to the point. It informs the customer in simple, clear language of the risks of futures trading which do not vary depending on the particular contract traded. Hence, there is no need for information to be required on individual contracts. The customer must receive the statement and also date and sign an acknowledgment that he received it and understands the risks involved *before making his first trade*. The text of the risk disclosure statement is set forth in §1.55, 17 C.F.R. §1.55 (1982). (In the case of futures traded through pools and managed account programs, more extensive disclosure is required because the customer is purchasing management advice or skills and in the case of a pool an interest in a particular entity - *See* Part 4 of the CFTC's regulations.)

For commodity options, CFTC rules require that FCMs provide to customers a commodity options risk disclosure statement which includes essential information pertinent to certain special aspects of options trading. This includes a description of, *e.g.*, the mechanics and risks of options trading and the special risks associated with deep-out-of-the-money options; and a statement as to the amount of the premium or applicable margin requirements. All disclosure must be in plain English, with much of the actual wording expressly specified by rule. Again, the customer must acknowledge in writing having read and understood the document *before* the first option trade is made. Additionally, as mentioned in Part C, certain additional disclosures may have to be made to ensure that each option customer makes an informed decision on whether to trade. To make this determination, the FCM must acquaint itself with the personal circumstances of each option customer. Further, CFTC rules prescribe additional disclosure requirements for the handling, by FCMs, of option customer discretionary accounts. Specifically, FCMs must explain the nature and risks of the trading strategy which will be employed in such cases.

E. Advertisement and Sales Literature

The rules of securities options SROs establish detailed standards concerning the content and manner of presentation of options advertisements and sales literature. All advertisements and sales literature (except completed worksheets) must be approved in advance by a firm's Compliance Registered Options Principal. Broker-dealers also are required to submit advertisements to options SROs for approval or review prior to use.

The CEAct's general antifraud provisions govern futures advertisements by FCMs. CFTC regulations for pool operators and commodity trading advisors specifically prohibit them advertising in a manner which is false, misleading or deceptive, and the CFTC has issued a release providing guidance as to the types of advertisements prohibited by this rule. The advertising of simulated or hypothetical past performance results of pool operators and commodity trading advisors must be accompanied by a prescribed statement to alert customers to the inherent limitations of such results.

The CFTC's option rules contain provisions governing options "promotional materials," including a stipulation that contract markets require all promotional materials to be submitted to them promptly by member FCMs to determine that such materials are not fraudulent. The options rules also require contract markets to adopt and enforce rules which prohibit fraudulent or "high-pressure" sales communications by member FCMs.

All promotional materials pertaining to options trading under the pilot options program must be submitted promptly to NFA, providing NFA an opportunity to review the materials and determine whether such materials are fraudulent. NFA also prescreens members which are not members of any other SRO before permitting option trading.

Some contract markets also have adopted rules regulating advertisements, and may require the prior submission of advertisements for approval as a sanction for previous failure to meet the contract market's guidelines and standards.

F. Supervision

The options SROs require that (i) member firms develop and implement a written program for the supervision of their options business; (ii) those options programs be under the overall supervision of a designated senior registered options principal; (iii) compliance responsibilities be under the supervision of a designated compliance registered options principal; and (iv) all branch offices (except those with less than three options representatives) be supervised by a principal-qualified branch office manager.

Exchange rules governing the supervision of debt and foreign currency options essentially require a parallel supervisory structure, with the responsibility for supervising trading in those options resting with persons specifically qualified with respect to those options.

CFTC rules require that an FCM diligently supervise the handling of all futures accounts carried, operated or advised by the firm and all other activities of its principals, employees and agents relating to its futures business. The CFTC has also provided guidelines as to the type of measures FCMs should adopt to comply with these requirements. See 43 Fed. Reg. 31886, 31889 (July 24, 1978).

As a condition to being designated as a contract market for option trading, a board of trade must adopt rules which impose stringent supervisory obligations on their member FCMs and also implement procedures for, and conduct comprehensive sales practice audits, of their member FCMs. Such sales practice audits must be of sufficient scope to enforce the contract market rules, including investigation for the improper handling of discretionary accounts, inadequate internal supervision, fraudulent or high pressure sales communications, compliance with disclosure requirements, and improper handling or disposition of option customer complaints. A contract market also must adopt and enforce rules which require member FCMs to take the following special precautionary measures with respect to discretionary accounts: (1) approve such accounts for discretionary trading before trading commences; (2) approve, initial and date all discretionary orders; (3) identify each order as discretionary at the time of entry; (4) fully explain the nature and risks of the strategy to be applied to trading in such accounts; and (5) conduct frequent reviews of such accounts.

NFA rules also require a member to diligently supervise its employees and agents in the conduct of their commodity futures activities for the member. NFA rules further require continuous supervision by member FCMs for compliance with NFA rules with respect to discretionary accounts.

G. Performance Fees

The SEC does not have any rules applicable to broker-dealers concerning performance fees. The rules of the option SROs, however, prohibit member firms and their associated persons from receiving "performance fees" (*i.e.*, sharing in customer profits or losses, except to the extent they contribute capital to the account). Section 205 of the Investment Advisers Act, 15 U.S.C. §80b-5 and SEC regulations, also impose restrictions on the receipt of performance-based compensation by investment advisers. The SEC recently proposed liberalizing certain of these restrictions. This proposal is to be published in the *Federal Register* shortly.

The CEAct, through its antifraud provisions, prohibits the charging of performance fees by FCMs which are fraudulent. For pool operators and commodity trading advisors, the CFTC has adopted rules requiring the full disclosure of all fees, including possible conflicts of interest arising therefrom. Moreover, where such a fee is determined by reference to a term such as "net assets," "gross profits," "net profits," or "net gains," that term must be specifically defined. These disclosures must be made before the CPO or CTA may directly or indirectly solicit, accept or receive funds, securities or other property from a prospective participant in a pool or before soliciting or entering into an agreement with a prospective client, respectively.

H. Insider Trading (Material Non-Public Information)

The securities laws provide that a person in possession of material inside information either must disclose it or abstain from trading in or recommending the securities concerned while such inside information remains undisclosed. Thus, a corporate insider, *e.g.*, a director, must disclose to the other party to a transaction in the corporation's shares material information which is known to him by virtue of his insider status but not to the other party

This doctrine is premised on the fact that in the securities markets the information most pertinent to an investment decision frequently relates to a particular company, *e.g.*, an undisclosed pending merger or a not-yet-released report showing heavy losses and that certain individuals because of their relationship to a firm may be in a position to know such information in advance of it becoming publicly available and use that information (or provide it to "tippees" who use it) to make large profits by buying stock (or options) in the company before favorable news becomes public or selling company stock before bad news causes a drop in prices.

The concept of "insider trading" as it is generally understood under the securities laws is not precisely applicable to futures regulation, as there is no equivalent of inside corporate information in futures (or options thereon). Congress, however, recently directed the CFTC to study and report on the nature and extent of trading in futures markets by persons possessing material information regarding cash or futures transactions that is not generally known to the public and the adequacy of the CFTC's authority to prevent market and customer abuses resulting therefrom. The CFTC is to report its findings and recommendations to its Congressional oversight committees not later than September 30, 1984. *See* the Futures Trading Act of 1982, Pub. L. No. 97-444, §236, 96 Stat. 2325 (1983).

I. Clearing House Guarantee

Although the traditional futures protection of the clearing house guarantee of contract performance has been engrafted onto securities option regulation, i.e., OCC guarantees and is ultimately responsible for the performance of each option transaction effected on the options exchanges, it does not exist in the regular securities markets.

Every futures contract (and option thereon) is guaranteed by the exchange's clearing organization. Thus, neither party to a transaction is dependent upon the other direct party for gains or losses that accrue. Clearing organizations have substantial capital, guaranty funds and/or assessment powers against member firms as has been determined to be necessary and appropriate to insure the clearing organization against potential loss in the event of a default by a clearing member firm on its obligations.

J. Market Surveillance

Market surveillance in the securities industry is performed by the securities exchanges, with the SEC limited to an oversight role only.

The CFTC directly monitors all futures contracts (and options thereon) with particular emphasis on the sensitive period immediately prior to maturity (or expiration). The CFTC meets at least once a week to review the markets. (The USDA, SEC, Fed and Treasury have standing invitations to attend the pertinent parts of these meetings and, in the event that noteworthy activity of particular interest to them may be discussed, a special invitation is issued. In addition, the surveillance staffs of the CFTC, SEC, Treasury and the New York Fed hold quarterly meetings to discuss the markets in government securities.) At all times the CFTC knows or has procedures to obtain both the identity and the open trades of every large participant in the futures (and options) markets as well as related information, e.g., a trader's holdings in the underlying commodity.

This intensive market surveillance is designed to detect and prevent the development of market conditions that may distort or adversely affect the efficiency of these markets and their usefulness for price discovery and hedging purposes. Thus, the process is prophylactic in nature and the CFTC is directly involved on a day-to-day basis.

K. Protection Against Broker Insolvency

Securities firms are not required to segregate 100% of customer funds. The Securities Investor Protection Act of 1970 ("SIPA") provides insurance protection for customers of broker-dealers which are members of the Securities Investor Protection Corporation ("SIPC"). (Virtually all broker-dealers are members of SIPC.) Currently, the limits of protection under SIPA are $500,000 per customer, of which $100,000 may be for cash. Options customers are similarly entitled to SIPA protection.

Since its creation in 1971, SIPC has paid out approximately $150 million in customer losses - an average of over $11.5 million annually. This insurance program is funded by an assessment on broker-dealers' revenue, a cost which ultimately is passed on to the investing public.

The institution of a proceeding under SIPA terminates a bankruptcy liquidation. Members of SIPC are liquidated under the Bankruptcy Code only if SIPC does not file an application in a pending bankruptcy case or the court determines that customers are not in need of SIPA protection.

All commodity customer funds must be separately segregated and safeguarded against use by FCMs for their own purpose, or for any purpose except to satisfy the trading obligations of the particular customer on whose behalf they were deposited.

Over the approximately 45 years since records of commodity customer losses were first maintained in 1938, an average of only $176,000 per year has been lost by regulated commodity customers. Accordingly, Congress did not find it necessary to create a commodities account insurer in 1971 when it created SIPC or later when it established the Commission in 1974. Although Congress directed the Commission at that time to study the need for such a program, the Commission's report on the subject, submitted to Congress on November 1, 1976, concluded that the risk of customer losses was too low to justify the costs of an insurer. Consistent with these conclusions, no legislation on this subject has ensued.

The CFTC requirement of 100% segregation of customer funds is a substantial protection to customers in the event of commodity broker insolvency. Moreover, the Bankruptcy Reform Act of 1978, which requires the liquidation of bankrupt commodity brokers, and Commission regulations adopted thereunder, provide special protections for commodity customers and firms. For example, these provisions prevent the flow of margin from being reversed as a preference; insulate transfers of accounts pursuant to CFTC rules from attack; and give customers priority both as to segregated and improperly nonsegregated funds.

L. Investor Remedies

Several provisions of the federal securities laws grant investors express causes of action against securities professionals and others. In addition, rights of action also have been implied by the courts under some other provisions, particularly Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, although under many other provisions of the federal securities laws, implied causes of action have been held not to exist. In Rule 10b-5 cases, an injured customer must prove actual fraudulent intent in order to recover damages. Investors may also pursue remedies under state general antifraud statutes as well as state "blue sky laws," In addition, the securities SROs have established uniform arbitration procedures for the handling of investor grievances against broker-dealers. There is no reparations procedure as exists under the Commodity Exchange Act.

The Supreme Court held in 1982 that purchasers and sellers of futures contracts have implied rights of action under major sections of the Commodity Exchange Act. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, et al., 456 U.S. 353 (May 3, 1982). Congress codified that remedy in the Futures Trading Act of 1982, explicitly authorizing private rights of action against certain persons, including contract markets, clearing organizations, and registered futures associations, and setting forth the conditions under which such actions are permitted. The Futures Trading Act of 1982, Pub. L. No. 97-444, §235, 96 Stat. 2322 (1982).

In addition, the CFTC's unique reparations procedure permits aggrieved commodity customers to file claims for damages against CFTC registrants. The Commission has held that scienter is not required under the general antifraud provision of the Act, Section 4b, the CEAct analogue to Section 10b.

The Act and CFTC regulations also require each contract market and registered futures association to provide an arbitration procedure for the settlement of customers' claims against its members and employees. Rules implementing this requirement are subject to CFTC review and approval. As required, the NFA has developed a uniform industry-wide arbitration system. Investors may pursue remedies under general state antifraud laws, as well.

M. Safeguarding of Customer Funds

SEC rules require that funds deposited by customers must be segregated from a broker-dealer's own funds. However, margin deposits made by one customer may be loaned out by a broker-dealer to other customers.

The Commodity Exchange Act requires FCMs to "separately account for" (or segregate) 100% of the funds deposited by each customer. Those funds may not be commingled with of the FCM, and may not be used for any purpose other than to cover the trading obligations of the particular customer for whom they were deposited. As previously mentioned, the loss of funds by regulated commodity customers has been minimal.

N. Minimum Financial Requirements

Since 1979, with the exception of certain minor differences, the SEC and the CFTC both compute net capital in a substantially identical fashion. With respect to the accounting treatment of commodities-related items, the SEC generally defers to the CFTC's treatment.

The specific net capital requirement for broker-dealer/FCMs is the higher of the amount established by the SEC or the CFTC.

The method of computing net capital, with some minor exceptions (related primarily to FCMs that are not registered as broker-dealers), are uniform for FCMs and broker-dealers. In revising its minimum financial and related reporting requirements during the period 1975 through 1978, the CFTC deliberately sought to conform its requirements to the SEC. As further revisions are needed, the CFTC continues to seek to harmonize its financial requirements with those of the SEC. With respect to the accounting treatment of securities-related items, the CFTC generally defers to the SEC's treatment.

The specific capital requirement for FCM/broker-dealers is the higher of the amount established by the CFTC or the SEC. Because the volume of securities-related business of virtually all FCM/broker-dealers is greater than their futures business, FCM/broker-dealers satisfy the CFTC's minimum adjusted net capital requirement by complying with the SEC's net capital requirement.

O. Testing

The SEC presently has no testing requirement other than for SECO broker-dealers. The option SROs, however, require registered representatives to pass a general securities examination that includes option questions and option supervisors to pass a general examination plus a separate option principal's examination. Persons selling, or supervising the sale of, options on debt securities or options on foreign currencies also must complete separate examinations which test knowledge of these options and the markets for the underlying instruments.

At present, several of the commodity exchanges require the associated persons of their member FCMs to pass a written proficiency examination. Although the CFTC has proposed a rule which would require associated persons to pass a written proficiency examination, 46 Fed. Reg. 20679 (April 7, 1981), action on this proposal has been deferred since NFA, as required by the 1982 amendments to the CEAct, is scheduled to implement a testing program for commodity sales personnel, their supervisors and all persons for which it has registration responsibilities. It is anticipated that the program will begin to be phased in over the next 12-18 months.

P. Speculative Position Limits

The options exchanges, at the SEC's direction, have imposed or proposed position and exercise limits on each of the option contracts they trade or are seeking authority to trade. The position limits apply to the aggregate position on either side of the market (i.e., long calls plus short puts or vice versa) and there is no netting of hedged or spread positions. Position limits refer to the limit on the total number of contract puts and calls on the same side of the underlying security that any person may hold. Exercise limits refer to the total number of puts or calls that can be exercised in any five business day period. No position or exercise limits exist for the securities markets.

Futures exchanges are required to establish and submit for CFTC approval speculative position limit rules for all financial (as well as other) futures and option on futures contracts. The CFTC has approved most of these rules and is currently reviewing the remainder.

Each of the rules approved to date specifies speculative position limits that apply to all future delivery months combined on a net basis (and, in some cases, to individual delivery months). The position limits for options on futures apply to the aggregate position on either side of the put or call market (i.e., long or short positions in either puts or calls) that is uncovered (i.e., not matched by an opposite futures contract or by a position in the underlying commodity). In addition, the rules provide procedures for aggregating accounts for purposes of detecting violations of the limits, exceptions for bona fide hedge and (in some cases) arbitrage and intermarket spread positions, and procedures to be followed by traders who seek such exemptions. Each rule incorporates the CFTC's general definition of bona fide hedging by reference, thus requiring that positions exempted from the speculative limits as hedges be taken for the purpose of reducing risk exposure. However, hedge and other exemptions are granted only on a case by case basis after all relevant information on the position is submitted to the exchange for review. Moreover, a contract market may limit bona fide hedging positions which its determines are not in accord with sound commercial practices or exceed the amount which may be established and liquidated in an orderly fashion.

90-Day U.S. Treasury Bills - 5,000 contracts net long or short ($5 billion principal amount) for all futures combined; 2,500 contracts in spot month three weeks prior to first delivery day; 750 contracts in spot month one week prior to first delivery day.

Foreign Currencies (Swiss Franc, Japanese Yen, Deutsche Mark, Canadian Dollar, British Pound) - 6,000 contracts net long or short (about $300 million underlying currency value) for all futures combined.

Domestic Bank Certificates of Deposit - 5,000 contracts net long or short ($5 million principal amount) for all futures combined; 4,000 in spot month; 750 in spot month starting one day prior to delivery period.

Eurodollars - 5,000 contracts net long or short ($5 billion principal amount) for all futures combined.

Stock Index Futures - 5,000 contracts net long or short ($250 to $500 million contract value) for all futures combined on broad-based indices.

The following exchange speculative limits have been approved for options on financial futures.

Treasury Bond Futures Options - 2,000 contracts ($200 million principal amount).

Stock Index Futures Option - 2,000 contracts on broad-based indices ($250 to $500 million contract value). */

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*/ The face value of the futures and options contracts have been furnished for the purpose of comparison with the face value of options on financial securities furnished by the SEC. It should be noted, that because margin on such contracts is not an extension of credit and profits and losses must be settled daily, the face value is not relevant to the amount of margin which is required.

Attachment B

COMPARISON OF CURRENT AND PROPOSED CUSTOMER PROTECTION RULES GOVERNING DEALER OPTIONS WITH RULES GOVERNING EXCHANGE-TRADED OPTIONS AND LEVERAGE TRANSACTIONS

This comparison was prepared by the staff of the Front Office Audit Unit of the Division of Trading and Markets and is limited to the customer protection provisions of the various regulatory schemes. This comparison is for discussion purposes only. The staff recognizes that each of the instruments subject to regulation are different. Therefore, the protections which should be afforded customers, as well as other regulations governing these instruments, also may differ.

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
Eligibility To Solicit Moratorium in effect for new firms (Regs. 31.1 and 31.2). Firm offering contract must be registered as Leverage Transaction Merchant (Reg. 31.5). Salesmen must be registered as LTM APs (Reg. 31.5). Membership in Futures Association under Section 17 not required.	Eligibility To Solicit Unlawful Transactions (Reg. 33.3) FCM registration required for firm (Reg. 33.3(b)(1)(i)). AP registration required for FCM salesmen. Membership on contract market on which options traded or membership in Futures Association under Section 17 required (Regs. 33.3(b)(1)(A) and (B)). or Registration as IB and membership in Futures Association or membership on contract market which has adopted Commission approved rules which provide that option activity of IBs will be regulated in a manner equivalent to FCMs (Reg. 33.3(b)(ii)(A)). or IB operating pursuant to guarantee agreement and FCM which has signed such agreement is a member of a self regulatory organization which has adopted Commission approved rules that provide for regulation and monitoring of activity of the IB equivalent to that required of contract markets with respect to their member FCMs.	Eligibility To Solicit Unlawful Transactions Reg. 32.3) Moratorium in effect for grantors (Reg. 32.11). FCM registration required for firm marketing options (Reg. 32.2). AP registration required for salesmen (Reg. 32.3). Notification of dealer option marketing activity by firm to Commission required (Reg. 32.12(a)(8)). No requirement to register as grantor of dealer options. Membership requirement in Futures Association under Section 17 not specified. Neither guaranteed nor non-guaranteed IBs may solicit or offer dealer options.	Eligibility To Solicit Would have made registration as a grantor required under new registration category (Proposed Reg. 3.15).

Leverage	Exchange Traded Options	Current Dealer Options	**Proposed April 1981 Regulations**
Contract Designation	Contract Designation	Contract Designation	Contract Designation
Specific contracts sold must be registered with the Commission (Reg. 31.6).	Contract must be submitted to Commission and exchange must be designated as contract market prior to being sold (Reg. 33.4).	Registration or submission of contract specifications or conditions not required.	Would have required application for approval of specific commodities for which options would be granted (Proposed Reg. 3.15).

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
Financial Requirements and Cover of Obligations	Financial Requirements and Cover of Obligations	Financial Requirements and Cover of Obligations	Financial Requirements and Cover of Obligations
Adjusted net capital of at least $2.5 million, plus 20% of market value of uncovered position of customers (Reg. 31.9). Certified financial reports required on an annual basis (Reg. 31.13). LTM must maintain cover of at least 90% of the amount of physical commodities subject to open leverage contracts, and at least 25% of the amount of physical commodities subject to open long leverage contracts must be covered by the types of permissible cover set forth in reg. 31.8(a)(2). (Reg. 31.8(a)(1).	No special financial requirements other than those generally required of FCM or IB -- e.g., annual certified financial report. Option purchaser generally must pay full amount of premium. Option seller margins set by clearing organization. Because of this, the FCM carrying short option positions at greater risk than FCM carrying long option positions, so rule 1.17(c)(5)(iii) requires the FCM to take a 4% capital charge for the market value of options granted (sold) by option customers.	Grantor must have net worth of $5 million at time of solicitation or acceptance of option order (Reg. 32.12). Net worth must be certified annually by independent public accountant (Section 4c(d)(2)(A)). There is no specific coverage of option obligations required in the Commission's regulations, nor is "cover" defined.	Grantor would have had to maintain net worth of $5 million and adjusted net capital equal to or in excess of $4 million plus 10% of the market value of the physical commodities subject to each uncovered commodity option granted by the dealer option grantor (Proposed Reg. 32.12). "Cover" would have had same meaning as set forth in Reg. 1.17(j). Cover generally defined as offsetting position in physical commodity, futures or options.

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
Repurchase of Contracts Sold	Repurchase of Contracts Sold	Repurchase of Contracts Sold	Repurchase of Contracts Sold
Leverage merchant prohibited from offering new contracts at any time it is not offering to repurchase any leverage contracts previously entered into (Reg. 31.10). See also proposed amendment at 50 FR 102, 105 (Jan. 2, 1985).	(Not applicable)	The person soliciting or accepting the order must furnish a disclosure document containing a statement that generally an option customer will be unable to sell any option purchased in any market to recover any of the purchase price, but may only liquidate by exercising an option before the expiration date of the option (Reg. 32.5(a)(6)(ii)).	Would have required disclosure statement to contain a statement as to whether grantor is under any obligation to repurchase an option from a customer, a description of any conditions that may exist or occur that would affect such obligation and a description of conditions under which customers could recover a portion of repurchase price or realized profits by reselling the option to the grantor rather than exercising it (Proposed Reg. 32.5(a)(8)).

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
Disclosure Statements	Disclosure Statements	Disclosure Statements	Disclosure Statements
A disclosure statement must be furnished to each leverage customer and a signed and dated acknowledgment that the customer has received and understood the disclosure statement must be on file with the LTM prior to the opening of a leverage account. (Reg. 31.11(a)). Prescribed language of disclosure statement contains following provisions(Reg. 31.11(a)(1)). a) An illustrative break even point calculation must be attached. b) Prices and charges vary for each LTM and customer should compare prices with other LTMs and exchange traded contracts. c) Margin calls can cause account to be liquidated with no notice if maintenance margin goes below 50%. Customer has right to reestablish for 5 business days at prevailing bid price with no additional fees. d) Right to rescind for first time customers. e) Customer may have to take delivery of contract in order	A disclosure statement must be furnished to each option customer and acknowledgment signed and dated that the customer has received and understood the statement. The statement must be on file at the FCM prior to the entry of any option orders. Such disclosure document and acknowledgments must be retained by the FCM or IB (Reg. 33.7). Disclosure statement required to contain a description of the purchase price of the option including premium, commissions, costs, fees and other charges and a statement that commissions and other charges may vary widely among FCMs and IBs and that it is advisable to compare rates when opening an option account (Reg. 33.7(b)(2)(iv)). Regulation does not require breakeven calculations expressed in percentage terms or dollar amounts or illustrative examples of transaction cost and "break even" points, although a statement that the customer should calculate this is required (Reg. 33.7(b)(5)). Disclosure statements must be	A disclosure statement must be furnished to each option customer or prospective customer prior to the entry of any commodity option transaction by the person soliciting or accepting the order (Reg. 32.5). There is no requirement that the FCM have on file a signed copy of a customer acknowledgment that a disclosure statement has been received before an order for a dealer option is placed. There is no requirement that the grantor prepare or approve the disclosure statement used by an FCM marketing the grantor's options or submit such disclosure statement to the Commission for approval of the document. Grantor, however, is jointly and severally liable for unlawful sales practices of FCMs. (Reg. 32.12(a)(2)). The disclosure statement must contain a listing of the elements comprising the purchase price including the premium, mark-up or commission, cost, fees and other charges for purchasing the option and exercising the option. No mention of disclosure of costs involved in selling option back to dealer (Reg. 32.5).	Would have required that the disclosure statement be sent and a signed and dated acknowledgment be on file with FCM before a commodity option transaction could be completed (Proposed Reg. 32.5). No requirement that the grantor approve disclosure statements used by FCMs and IBs marketing options of grantor or that such disclosure statement be submitted to Commission by grantor. Would have required description of all costs involved when option is sold back to grantor or exercised. Would have required disclosure statement to contain an illustrative option transaction set forth in a format which shows all costs involved in the transaction and the calculation of the price the underlying commodity will have to exceed for the customer to realize a profit i.e., break-even point. Would have required that such example be prepared at time disclosure statement is sent out to reflect current option and underlying commodity prices.

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
to liquidate as LTM not required to repurchase leverage contract at all times (although the LTM must offer to repurchase any outstanding leverage contracts at any time it is offering to sell any leverage contracts).	reviewed by contract market and NFA during sales practice audits for compliance with regulations and exchange rules (Reg. 33.4(c)).	Regulation does not require any break even calculations expressed in percentage terms or dollar amounts or any illustrative examples of transaction costs and "break even" points.	
Disclosure statement must contain description of each leverage contract with duration and expiration described (contracts are approved by Commission). A description of all charges including initial charges, carrying charges, termination charges and bid and asked prices must be included.	Disclosure rules do not relieve an FCM or an IB from any obligations under the Act or rules, including the obligation to disclose all material information to existing or prospective customers even if the information is not specifically required by rule 33.7. (Reg. 33.7(f)).	Regulation does not require statements that premiums, commissions or mark-ups may vary significantly from grantor to grantor and FCM to FCM.	
LTM required to submit to Commission 3 copies of each disclosure document it intends to use no less than 21 days prior to date it intends to use the document (Reg. 31.11(e)(1)).			

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
Segregation	Segregation	Segregation	Segregation
All funds received by LTM for leverage contract must be treated as funds belonging to leverage customers and separately accounted for. Such funds may be used for cover as defined (Reg. 31.12) but may not be used to purchase encumbered warehouse receipts.	Condition of designation is that a board of trade require that the clearing organization collect from each of its members and that each FCM collect from each of its option customers the full amount of each option premium at the time the option is purchased (Reg. 33.4). All futures contract segregation requirements apply to FCMs.	At least 90% of funds received by an FCM as payment of the purchase price in connection with a commodity option transaction must be treated and dealt with as belonging to option customers and segregated until options are exercised or expire (Reg. 32.6).	Would require 100% of funds received by an FCM as payment of the purchase price in connection with a commodity option transaction to be segregated. Expressly would require FCM to segregate all funds received from option customer in anticipation of but prior to purchase of an option. FCMs would not be required to segregate those positions of the purchase price not payable to the grantor (Proposed Reg. 32.6).

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
Customer Confirmation	Customer Confirmation	Customer Confirmation	Customer Confirmation
A written transaction confirmation statement must be mailed to customer within 24 hours after entry into a contract. Such confirmation must contain (Reg. 31.11(k)):	A written confirmation must be issued not later than the next business day to each option customer containing at least the following information (Reg. 1.33(b)):	Not more than 24 hours after execution of a commodity option transaction a written confirmation must be issued to the purchaser containing at least the following information (Reg. 32.5(d)):	Would have required a written confirmation be sent within 24 hours after entry of commodity option order containing at least the following information (Proposed Reg. 32.5):
a) Rescission statement b) Date of transaction c) Transaction identification number d) Name of leverage commodity e) Expiration date of contract f) Price g) Number of contracts h) Total costs of contracts; asked price times number of contracts i) Initial charges incurred by leverage customer j) Carrying charges in dollars per contract for one year k) Termination charges per contract if liquidated or delivery is taken l) Bid - ask spread at close of business on day of transaction m) Initial margin in dollars per contract n) Minimum margin in dollars per contract o) Maintenance margin in dollars per contract p) Description of commercial or retail cash series filed	a) Customer account number b) A separate listing of the actual premium, mark-up if applicable, commissions, costs, and other charges incurred in connection with the transaction c) The underlying futures contract or physical d) The final exercise date of the option e) The date of the transaction f) Upon expiration or exercise, a written confirmation statement containing: date of transaction, option involved, details of futures contract or physical position resulting from exercise and, if applicable, final trading date of contract for futures position incurred.	a) The actual amount of the purchase price including a separate listing of the premium, mark-up on premium, costs, fees and other charges b) Striking price c) Total quantity and quality of the underlying commodity which underlies the contract d) The exercise date of the option and in the case of an option on a contract of sale for future delivery, the final trading date of such contract e) The execution date.	a) Actual amount of purchase price including a separate listing of the premium, costs, fees, and all other charges b) Actual amount or if not known, bona fide estimate of any costs or fees which would be incurred in exercising the option and/or reselling the option to the grantor c) The strike price d) The commodity, grade or denomination and total quantity that may be purchased or sold upon exercise of the option e) Expiration date of the option f) Spot value of commodity underlying the option g) Date option was granted h) Amount or bona fide estimate of amount by which underlying commodity must rise or fall in order for customer to realize a profit through exercise, including all costs and fees incident to exercise

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
in accordance by the LTM under Reg. 31.6.			i) Source of spot price used in break even calculations and information as to where customer can obtain timely quotes on spot prices j) Format of required confirmation prescribed.

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
Monthly Statements	Monthly Statements	Monthly Statements	Monthly Statements
As of the close of the last business day of each calendar month or as of any regular monthly date selected by the LTM a statement must be issued to each leverage customer which shows (Reg. 31.15):	Each FCM must promptly furnish in writing to each commodity option customer that has an open position or purchased or liquidated a position as of the close of the last business day of each month or as of any regular monthly date selected a statement which clearly shows (Reg. 1.33(a)):	No existing requirement in regulations requiring an FCM or grantor to issue monthly statement to dealer option customer.	Proposed regulations would not have required a monthly statement be issued to option customers by FCM or grantor.
a) All leverage contracts terminated during the reporting month by leverage commodity and contract, the number of contracts involved, the transaction identification numbers, whether the termination involved repurchase, liquidation or delivery, the date the contract was initially entered into, the value of the customer's position when terminated and the realized profit or loss on the contract b) The open leverage contracts with dates and prices at which they were initiated along with the maturity dates, and the unrealized profit or loss on each contract marked to the market on the basis of the LTM's bid price c) The net ledger balance in the customer's account and a complete accounting of any customer funds held in the account	a) All commodity options purchased, sold, exercised or expired during monthly reporting period identified by underlying futures contract or underlying physical, strike price, transaction date, and expiration date b) Open commodity option positions carried for customer as of the end of the monthly reporting period, identified by underlying futures contract or underlying physical, strike price, transaction date, and expiration date c) All open option positions marked to the market and the amount each such position is in the money, if any d) Any customer funds carried in customer account e) Detailed accounting of all charges and credits to customer's account during the		

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
d) A detailed accounting of all charges and credits to the previous ledger balance during the month including all customer funds received or disbursed and all commissions and fees incidental to the contract as well as all realized profits and losses e) Any securities or other property deposited with the LTM which represent leverage customer funds f) Prescribed notice to contact LTM if customer believes statement in error g) Duplicate confirmation must be sent to controller of account if other than customer's spouse, parent or child.	monthly period, including all customer funds received or disbursed, premiums charged and received and realized profits and losses. For accounts in which there are neither open positions at the end of the statement period nor any changes to account balance, such statements must be issued not less than every three months.		

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
Deep Out of the Money Solicitations	Deep Out of the Money Solicitations	Deep Out of the Money Solicitations	Deep Out of the Money Solicitations
Not applicable.	Board of trade must require each member FCM to adopt and enforce written procedures pursuant to which it will be able to supervise each option customer's account including solicitations for all types of options (Reg. 33.4(b)(5)). Board of trade also must adopt rules which provide for identification and supervision of deep out-of-money options (Reg. 33.4(b)(2) and (Reg. 33.7(b)(6)). Board of trade required to establish program for sales practice audits of member FCMs. Programs are required to include review of deep out-of-money sales and solicitations (Reg. 33.4(c)). The disclosure statement notifies potential option purchasers that the chance of profiting on deep-out-of-the-money options is remote. (Reg. 33.7(b)(5)).	Deep out-of-money options are not mentioned in existing Part 32 of the regulations nor in disclosure statement required for dealer options.	Deep out-of-money solicitations were not mentioned in proposed regulations.

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
Discretionary Accounts and Supervision	Discretionary Option Accounts and Supervision	Discretionary Option Accounts and Supervision	Discretionary Option Accounts and Supervision
LTM required to keep a record in permanent form of the name and address of any person other than the customer who assumes operational control over an account (Reg. 31.14(b)(2)).	FCM required to keep in permanent form the name of anyone other than the customer who exercises control over an account (Reg. 1.37(a)).	No mention of discretionary accounts or required supervision contained in Part 32 of regulations.	No mention of discretionary accounts or required supervision contained in proposed regulations.
Confirmation statements and monthly statements go to both customer and controller of account (Reg. 31.15(c)).	Confirmation and monthly statements go to both the customer and person exercising control over account (Reg. 1.33(a) and (b)).		
Nothing specifically in regulations as to supervision and review of controlled accounts or as to review of order tickets either prior to or after execution.	Board of trade must adopt rules which pertain to discretionary accounts as follows (Reg. 33.4): a) FCM must ensure that the option customer is provided with an explanation of the nature and risks of the strategy or strategies to be used (Reg. 33.4(b)(9)(i), amended at 49 FR 44894 (Nov. 13, 1984)). b) An officer, general partner or branch manager must approve in writing a discretionary account prior to any trading (Reg. 33.4(b)(9)) c) FCM must identify as discretionary each order for a discretionary account at the time of entry and an officer or branch manager must approve, date and initial all discretionary orders (Reg. 33.4(b)(9))		

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
	d) FCM must frequently review discretionary accounts (Reg. 33.4(b)(9)). Board of trade mandatory sales practice audits must include review of discretionary accounts handling (Reg. 33.4(c)).		

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
Promotional Material	Promotional Material	Promotional Material	Promotional Material
LTM required to keep as records promotional materials, circulars, memoranda, publications, writings and all other literature or written advice distributed to customers or prospective customers (Reg. 31.14(b)(1)).	Board of trade must adopt rule which requires each member FCM to submit to board of trade all promotional material pertaining to options. Such material must be promptly reviewed to determine that material is not fraudulent (Reg. 33.4(b)(8)). Each FCM and IB must retain copies of all promotional material it provides, directly or indirectly, to option customers as well as the true source of authority for information contained therein (Reg. 33.8).	Each person accepting money or property from an option customer as payment must keep records which include solicitation or advertising material (including texts of standaridized oral presentations and of radio, television, seminar or simular mass media presentations) circulars, memoranda, publications, writings, and all literature or written advice distributed to option customers or prospective option customers (Reg. 32.7(a)). There is no provision in regulations for review of promotional material by dealers.	No changes proposed on existing regulation(s) pertaining to promotional materials.

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
Customer Complaints	Customer Complaints	Customer Complaints	Customer Complaints
No specific regulations pertaining to customer complaints. Recordkeeping requirements include all correspondence from or to a customer of the LTM and provide that such correspondence is open to review by authorized representatives of the Commission (Reg. 31.14). Reporting of customer complaints to any outside party not required.	Board of trade must adopt rules which require that with respect to all written option customer complaints and any oral complaints which result in, or would result in, an adjustment in excess of $1000: 1) The FCM retain all such written complaints and make and retain written records of such oral complaints 2) The FCM to send a copy of such complaints to board of trade and upon disposition, a copy of the record of such disposition 3) The FCM to make and retain a record of the date received, the AP or IB for the account, the account information, and a general description of the nature of the complaint and what if any action was taken by the FCM. (Reg. 33.4(b)(4).	No specific mention of customer complaints. Recordkeeping requirements include "all pertinent data and memoranda of or relating to such transactions" (Reg. 32.7(a)). Reporting of customer complaints to any outside party not required. Grantor is liable jointly and severally with any person that sells its options to an option customer for all damages sustained by my option customer in connection with the offer and sale of an option resulting from any unlawful act or omission or any breach of contract. (Reg. 32.12(a)(2)).	Proposed regulations had no specific mention of customer complaints. Recordkeeping requirements in Reg. 32.7 would not change. Proposed regulations would not have required any outside parties to be notified of customer complaints.

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
Right To Rescind	Right To Rescind	Right To Rescind	Right To Rescind
Customers of LTM entering a leverage contract for the first time with a particular LTM may rescind such contract during first three days following receipt of the confirmation under the following conditions (Reg. 31.23): a) Customer may be assessed actual price loss accruing to the position from time customer entered into contract to time contract rescinded. No other charges such as fees, commissions or interest charges may be assessed for a rescinded contract. b) Losses must be calculated by subtracting ask bid price at time of rescission from ask bid price at time contract entered into. c) LTM must make complete refund of all monies received except for actual price loss within 24 hours after notification of rescission.	No rescission provisions.	No rescission provisions.	No proposed rescission provisions.

Leverage	Exchange Traded Options	Current Dealer Options	Proposed April 1981 Regulations
Sales Practice Audits	Sales Practice Audits	Sales Practice Audits	Sales Practice Audit
No self-regulatory sales practice audit provisions contained in regulations. Membership in self regulatory organization not required for LTMs. CFTC carries out audit program for LTMs.	Condition of designation is that a board of trade establish procedures and conduct sales practice audits of member FCMs which engage in sales of option contracts to public. These audits are required to be of sufficient scope to enforce the contract market's rules, including investigation for the improper handling of discretionary accounts, inadequate internal supervision, fraudulent or high pressure sales communications, compliance with disclosure requirements, improper handling and disposition of option customer complaints, and, where applicable, the FCM's offer or sale of deep out-of-money options (Reg. 33.4(c)). Required sales practice audit programs are regularly reviewed by Commission staff as part of monitoring the enforcement programs of the contract markets and NFA (See Regs. 1.51 and 1.52).	No sales practice audit provisions contained in regulations. NFA does sales practice audits of FCMs for which it is the financial DSRO. CFTC audits other FCMs' dealer option activities.	No proposed sales practice audit provisions.

OPTIONS TRADING

Question (2)(A). The 3-year options pilot has now been completed. What factors of options trading, if any, should be examined further? Should the kind and number of options contracts approved for trading be limited?

Answer. The Commission is currently evaluating the experience of its three-year pilot program to permit exchange-traded commodity options on non-agricultural commodities. An integral part of this evaluation was the publication of a Notice of Proposed Rulemaking that requested public comment on proposed revisions to the regulations for options trading. 50 FR 35247 (August 30, 1985). The Commission is currently reviewing the non-agricultural pilot program experience generally and these comments on the proposed rule changes in particular. These proposed changes indicate the areas the Commission believes may require further examination, including:

1. making the pilot program permanent;
2. revising the definition of bona fide hedging to include options;
3. requiring automatic delisting criteria for options, similar to those for futures markets, when the volume of trading falls below a certain level; and
4. eliminating repetitive filings of promotional material and other documents by FCMs and introducing brokers with respect to the sales practice program.

In the context of the overall review of its experience with the non-agricultural option pilot program, the Commission will evaluate the necessity for limits on the kinds and number of option contracts. While this final review is not yet completed, if the Commission determines to terminate the pilot status and make the program for non-agricultural options permanent, there appears little need to limit the kinds and number of option contracts.

The Commission separately has proposed changes to its financial requirements for futures and option trading that were prompted by the failure of Volume Investors Corporation. The public comment period following Federal Register publication of these proposed revisions has not yet been completed. The proposed revisions include changes to the minimum financial requirements for futures commission merchants and introducing brokers which would require FCMs to calculate a "concentration charge" related to the futures and option positions they are carrying. The Commission will carefully evaluate the comments it receives on these proposals before determining what futher action may be appropriate.

With regard to options on futures contracts on agricultural commodities, the trading experience is much more limited since these options began trading in October 1984, two years after the first non-agricultural options began trading. The Commission's experience with agricultural options has been positive and suggests that the kinds and number of agricultural options could be expanded in the near future. Such an expansion is calendared for Commission consideration on March 25. Nevertheless, given the previous history of abuses and problems with agricultural options which resulted in the nearly fifty-year Congressional ban on such trading, the Commission believes it appropriate to act cautiously in relaxing the limits on the kinds and number of agricultural options.

Question (2)(B). If options trading is expanded, will the expansion consume significant Commission resources, over and above what is now used to support the regulation of option trading?

Answer. Two important factors suggest that an expansion of options trading would not consume significant Commission resources over and above what is now used to support the regulation of option trading and the normal increases required to regulate a dynamic industry:

(1) The option regulations have been conformed as much as possible to prevailing futures rules, and

(2) Significant direct responsibility for the regulation of options was placed on the exchanges.

Of course, as the new option contacts become actively traded, additional resources are required to monitor the trading in these new markets.

APPROVAL OF NEW CONTRACTS

Question (3). Some witnesses who appeared during the reauthorization hearings have compared the Commission's contract approval process with that of the SEC and have stated that the minimum time for CFTC approval of such contracts should be shortened.

Do you have any thoughts as to why one agency's contract approval process takes longer than another? What, if anything could be done to remedy this situation?

Answer. The Commission reviews all applications thoroughly, applying the statutory standards for review. These standards are, in many respects, unique to the Commodity Exchange Act. Moreover, in light of its experience, the Commission has promulgated Guideline No. 1, 17 CFR Part 5, Appendix A (1985). These criteria help to ensure that new contract market designations meet the appropriate standards for market integrity and for the protection of the public. It should also be noted that review of these contract market applications is undertaken in the context of a statutory time limitation. This necessarily reduces the Commission's scheduling flexibility, at times requiring an older, but unique application to precede a newer application which may face competitive pressure.

Despite its rigorous review of applications, the CFTC has had a very good record regarding the time taken to process contract market designations. Since the effective date of the last amendment to the Act, the time during which proposed applications for designation were under active Commission review has averaged seven months. Roughly one-third of futures contracts were under active Commission review for less than five months. Applications for proposed option contracts were also reviewed in a similarly timely fashion, with some being approved in three to four months.

Where delays have occurred, it has often been the result of flaws in the proposed applications which required additional work on the part of the submitting exchanges. The Commission tolls the review period only where an application is materially incomplete. The speed with which these defects are remedied significantly affects the overall time necessary to review the application. For example, roughly one-third of futures contract market applications were pending for an eight month or more period awaiting additional exchange action. In contrast, three-fourths of applications for contract market designations in options had no tolling period whatsoever and options on futures generally were designated in far shorter times. This difference may be ascribed to less complexity of these applications or perhaps to greater interest in their timely review and resubmission on the part of the exchanges occasioned by competitive considerations.

Finally, the Commission's recent experience has been that where comparable contracts have been filed with both the CFTC and the Securities and Exchange Commission ("SEC") within a few weeks or months of each other both agencies have made their determinations at roughly the same time. Examples of this include contracts in the European Currency Unit and various stock indices based on the over-the-counter market. In light of this record, the Commission does not believe that any changes are necessary to address the present situation.

DEFINITIONS OF HEDGING

Question (4). Mr. Gary Seevers has proposed that the Commission's definition of hedging activity be expanded to take the management of portfolio risk into greater account.

(A) Has the existing hedging definition restricted the use of futures markets?

(B) Can the Commission's hedging definition be expanded? If so, in what ways?

(C) Could the Commission assist other Federal and State agenices to understand what hedging means? If so, how?

(D) If the type of economic activity outlined by Mr. Seevers is not bona fide hedging activity, could a new category of economic activity (with trading limitations less restrictive than those applicable to speculative activity) be denominated to describe the use of futures markets in the management of portfolio risk, as outlined by Mr. Seevers?

Answer. The Commission's regulations contain a general description of transactions or positions which the Commission considers to be bona fide hedging. A basic element of this general definition is that hedge positions or transactions be for the purpose of reducing the risks attendant to the conduct of a commercial enterprise. Generally, this is evidenced when a firm's futures position is held as an offset to a position in the cash market, such as stock index futures sold against an existing portfolio of equity securities. Futures positions which do not have an offsetting cash position are likely to be risk-enhancing, rather than risk-reducing, and are therefore considered to fall within the Commission's general definition under only special circumstances.

The commodities exchanges are required to use the Commission's general definition for the purpose of determining exemptions from speculative position limits in financial futures markets. Accordingly, to the extent that particular large positions do not comport with the essential features of the Commission's definition (*e.g.*, that they do not result in commerical risk reduction) they would not be allowed to exceed speculative position limits. In this regard, existing speculative position limits in the more actively traded financial futures markets permit positions which equate to values ranging from one-half billion to over one billion dollars in terms of the underlying commodity.

Although the Commission's general definition of hedging is intended to describe the broad scope of risk-shifting transactions which may be possible in the diverse types of futures markets now under regulation, the Commission would not be unwilling to reexamine the definition from the perspective of portfolio risk management. However, either expansion of the current hedging definition or creation of an alternative economic activity category along the bases suggested by Mr. Seevers would likely result in exemptions from speculative position limits of positions which are not counter-balanced in the cash market. Any Commission re-examination of the heding definition therefore would proceed cautiously, in view of the significant impact which such very large one-sided positions may have on the market.

Finally, the Commission and its staff have continuously stood ready to assist other Federal and State agencies in understanding of hedging principles and the Commission's definition. This position is consistent with the Commission's stated belief that the public may view the Commission's general definition as the official guideline for commerical risk-shifting use of the futures market. However, such agencies have solicited Commission consultation only rarely. Part of the explanation of this limited consultation seems to be that such agencies have independent regulatory objectives to consider in determining under what circumstances the entities subject to their regulations may use futures markets. Accordingly, they have chosen to adopt their own criteria for market participation by various firms or institutions subject to their jurisdiction. Examples are those guidelines or standards applicable to banks, insurance companies, or savings and loan associations.

AUTOMATIC STAY PROPOSAL (SEC. 302 OF S. 2045)

Question (5). Mr. Gregory Glynn, a witness who appeared during the Committee's reauthorization hearings, has raised questions about the repeal of the "automatic stay" provision in section 17(h) of the Commodity Exchange Act.

Would you respond to the issues raised by Mr. Glynn in his prepared testimony?

Answer. In his testimony, Mr. Glynn essentially made two points. First, Mr. Glynn asserts his belief that NFA compliance rule 3-12, authorizing NFA to take a membership responsibility action ("MRA") without prior notice to the member, is contrary to the requirements of section 17(b)(9) of the Commodity Exchange Act ("Act") that NFA provide "a fair and orderly procedure with respect to the disciplining of members." Second, Mr. Glynn separately asserts that the automatic stay provisions in section 17(h) of the Act are a necessary element of due process that should be accorded NFA members. The Commission strongly disagrees with each assertion.

In adopting its own regulations establishing standards to govern Commission review of applications for registration as a futures association under section 17 of the Act, the Commission recognized that a self-regulatory organization exercising quasi-governmental responsibilities must provide due process to affected persons. 44 Fed. Reg. 20650 (April 10, 1979). Thus, its regulations require a registered futures association to provide a fair and orderly procedure in its disciplinary actions including, at a minimum, the procedural protections set forth in section 17(b)(9) of the Act. Such a procedure is particularly appropriate in view of the Commission's authority under section 17(m) of the Act to require membership in a registered futures association. In connection with the registration of NFA as a registered futures association in 1981, the Commission thoroughly reviewed compliance rule 3-12 and found that the procedures set forth in this rule comport with the standards established by the Act and the regulations thereunder.

Essentially, the rule provides that a member may be summarily suspended or required to restrict its operations when NFA's president, with the concurrence of NFA's Board of Directors or Executive Committee, has reason to believe that such action is necessary to protect the commodity futures markets, customers or other NFA members. Thus, although an MRA obviously has a disciplinary effect upon a member, its purpose is primarily remedial for the protection of the markets or those who participate in it.

As part of its continuing oversight responsibilities with respect to NFA and in connection with its recent report to Congress on the progress NFA has made in developing and implementing its self-regulatory program, the Commission reviewed the 76 MRAs that has been taken by NFA from January 1, 1983 through September 30, 1985, not one of which was appealed to the Commission. The Commission found that the MRA is a flexible and appropriate tool that can be used to require member action in a variety of ways. Of greatest importance, however, NFA has used MRAs in a manner consistent with the purpose and provisions of compliance rule 3-12 to obtain prompt action when necessary to protect customers.

For example, NFA issued an MRA which prohibited a commodity pool operator ("CPO") from soliciting any new funds or clients until the CPO prepared an adequate Risk Disclosure Document and maintained all the necessary books and records. NFA promptly lifted the MRA two months later when the CPO demonstrated compliance with the pertinent NFA rules. NFA similarly issued an MRA against a futures commission merchant ("FCM") within three days after an audit had uncovered evidence that the FCM was unable to demonstrate compliance with NFA capital requirements and had failed to maintain adequate books and records. The MRA prohibited the firm from accepting customer orders or making trades except for liquidation purposes, and further ordered the firm to transfer all customer positions and funds to other members FCMs. FCMs carrying the firm's accounts were separately required to notify NFA prior to making any disbursements of funds. This latter MRA was consistent with the Commission's own rules that require an FCM that is unable to demonstrate compliance with the minimum net capital rules to transfer all customer accounts to another FCM immedately and to cease acting in the capacity of an FCM until it can demonstrate such compliance.

The Commission, of course, will continue to monitor the conduct of NFA MRA proceedings and will take appropriate action if it determines that NFA is not fulfilling its obligations in this regard under the Act, the Commission's regulations and NFA's own rules. In this connection, the Commission should note that it recently approved an NFA rule amendment that will ensure that NFA members who aware disciplined will be afforded prompt hearings at reasonable locations. The amendment adopted by NFA would allow each regional business conduct committee, which consists of nine persons who are NFA members or associated with members, either to conduct the hearing itself or to designate a panel of three persons, at least one of whom is a member of that regional committee, to conduct the hearing.

Finally, the Commission would observe that the MRA procedures approved by the Commission differ little if at all from the summary procedures that Congress itself authorized the self-regulatory agencies subject to the oversight of the Securities and Exchange Commission to conduct in the 1975 Securities Acts Amendments. At that time, Congress recognized that self-regulatory organizations utilize governmental-type powers in carrying out their responsibilities and, therefore, must be required to conform their activities to fundamental standards of due process. S. Rep. No. 75, 94th Cong., 1st Sess. 25 (1975). Thus, Congress determined that summary proceedings conducted by a self-regulatory organization are not per se violative of the standards of due process.

As discussed above, NFA compliance rule 3-12 authorizes summary action whenever such action is deemed necessary to protect the commodity futures markets, customers or other NFA members. Similarly, sections 6(d)(3) and 15A(h)(3) of the Securities Exchange Act of 1934 as amended by the 1975 Securities Acts Amendments, authorize a national securities exchange or a registered securities association, respectively, to take summary action against a member if the exchange or association determines that the member is in such financial or operational difficulty that the member cannot be permitted to continue its business without endangering investors, creditors, the exchange or association, or other members. Like NFA compliance rule 3-12, these provisions of the Securities Exchange Act require that a prompt hearing be afforded the member following the summary action. The Supreme Court, in another context, has recognized that summary procedures suspending a licnese may be used to protect the integrity of a particular business and to protect the public from harm, and that due process is not offended thereby so long as a prompt hearing, as is required in NFA's rule, is provided thereafter. *Barry* v. *Barchi*, 443 U.S. 55 (1979).

The 1975 Securities Acts Amendments also provide a useful parallel in responding to Mr. Glynn's objection to the repeal of the automatic stay provisions of section 17(h). As the Committee may recall, the provisions of section 17(h) were drawn directly from the provisions of section 15A(g) of the Securities Exchange Act of 1934 as that provision was written prior to the 1975 Securities Acts Amendments. Thus, the Securities Exchange Act formerly provided for an automatic stay in the event of an appeal from a registered securities association disciplinary action.

In 1975, however, at the same time that Congress specifically authorized securities self-regulatory organizations to take summary action against members, Congress also amended the appellate provisions of section 15A(g) to delete the automatic stay requirement. As amended and recodified at section 19(d) of the Securities Exchange Act, the appellate provisions expressly state that an appeal—"shall not operate as a stay of such action unless the appropriate regulatory agency otherwise orders, summarily or after notice and opportunity for a hearing on the question of a stay (which hearing may consist solely of the submission of affidavits or presentation of oral arguments)."

Section 19(d) further provides that "[e]ach appropriate regulatory agency shall establish for appropriate cases an expedited procedure for consideration and determination of the question of a stay."

As discussed above, the legislative history of the 1975 Securities Acts Amendments indicates that Congress was aware of the due process concerns in adopting section 19(d), and determined that providing for a hearing with respect to the issuance of a stay on an expedited basis satisfied the requirements of due process. S. Rep. No. 75, 94th Cong., 1st Sess. 98 (1975). This judgment was subsequently affirmed by the U.S. Court of Appeals for the Seventh Circuit in *Allan* v. *SEC*, 577 F.2d 388 (1978).

In summary, the amendments to section 17(h) of the Act to which Mr. Glynn objects parallel the provisions of section 19(d) of the Securities Exchange Act of 1934. In particular, it requires the Commission to establish an expedited procedure for consideration of the question of a stay and, if these amendments are adopted, the Commission will promptly do so. In addition, the Commission notes that the amendments would do nothing more than put appeals of NFA disciplinary actions on an equal footing with appeals of exchange-imposed sanctions under section 8c of the Act, where a stay may be granted by the Commission, but is not a matter of statutory entitlement. The Commission, therefore, is confident that adoption of the amendment is fully consistent with the requirements of due process.

Moreover, the Commission would emphasize its belief that the failure to adopt this amendment would seriously undermine the effectiveness of NFA's MRA procedure which, by its very nature, is designed for use in instances where immediate action is necessary to protect the markets, customers or other NFA members. The appeal provisions of section 17(h) were intended to ensure fundamental fairness for members of the Association against possible arbitrary action. The amendments proposed would remedy the incidental effect of the current wording of section 17(h) and would strengthen the effectiveness of NFA's remedial procedures.

[Questions from Senator Cochran to Chairman Phillips and answers thereto:]

Question 1. Chairman Phillips, I know that that the CFTC is trying to work with the Chicago Mercantile Exchange and the Board of Trade to iron out differences over the audit trail proposal. I commend you and the exchanges for this cooperative effort. I am hopeful through this cooperation that a stronger self-regulatory system can be developed so that the confidence of our farmers in the markets will continue. My question is this, we know that the exchanges strongly believe that their joint proposal will provide for the best available audit trail. The commission has said that it needs more data to assess the viability of the exchange proposal. In this context, what consideration was given to the exchange proposal before issuance of the Commission's regulations?

Answer. The joint CBT-CME proposal presently before the Commission had not been submitted to the Commission prior to the Commission's vote to adopt the final audit trail regulations. Instead, the CBT and CME each had proposed different audit trail systems. The Commission carefully and extensively considered each proposal over a number of months, and, in fact, adopted many aspects of these proposals in its final rules (e.g., the use of exit times, separate opening and closing period timing, elimination of a technology requirement and elimination of any requirement that the broker write down the time).

Because the joint proposal by the CBT and CME now before the Commission is relatively new, and, in fact, has been evolving the Commission will need to evaluate the final product before it ultimately will be able to determine whether the proposal complies with the Commission's regulation. At this time, it appears that the system has the capability to comply.

Question 2. What would be the Commission's views concerning allowing the exchanges to implement and test their proposal for a trial period?

Answer. In adopting its new rules, the Commission permitted up to one year before exchange compliance systems would be required to have in operation their improved audit trails. The Commission believes this allows ample time for testing and implementing their systems. Moreover, the Commission, through its oversight program, will continue thereafter to work with the exchanges in achieving and maintaining compliance with the new rules.

[Questions from Senator Leahy to Chairman Phillips and answers thereto:]

Question 1. Why is the Commission seeking authority to alter or supplement National Futures Association rules? Has the NFA attempted to promulgate any rule inconsistent with current law?

Answer. At present, the Commission's authority with respect to NFA rules rests at two polar extremes: The Commission can either approve a proposed NFA rule or, if the rule is inconsistent with NFA's obligations under the Act or otherwise in violation of the Act or the Commission's regulations, the Commission can disapprove (or repeal) the rule. This contrasts with the authority of the Securities and Exchange Commission to alter, supplement or abrogate the rules of the National Association of Securities Dealers.

While the Commission would normally expect to approve an NFA rule submission, it is not inconceivable that NFA would propose a course of conduct that is inconsistent with the Act or the Commission's regulations and could not be approved. For example, NFA has recently adopted and submitted to the Commission a rule which would authorize NFA to grant temporary licenses ("TLs") to guaranteed introducing brokers prior to their registration with the Commission. The Commission, after careful consideration, declined to authorize TLs in such circumstances when it adopted regulations in this area in 1984.

Similarly, a situation could arise where changes in the Act or in the Commission's regulations may render invalid existing NFA rules on a particular subject. In such a case, however, merely disapproving NFA's rule could result in an unacceptable gap in the scope and coverage of NFA's rules in that area. Unlike the Commission's authority with respect to exchange rules—where the Commission is authorized to approve or disapprove and to alter or supplement those rules as may be necessary—the Commission is effectively authorized only to approve or disapprove an NFA rule. (While the Commission can alter some NFA rules under Section 17(k)(2), it can do so only if those rules relate to the governance of NFA.) Thus, if significant gaps were to develop in the rules governing NFA's minimum financial, sales practice, arbitration, proficiency testing or disciplinary programs, the Commission could do no more than ask NFA to take appropriate steps to remedy the situation. If NFA were to decline, the Commission's recourse could be either to suspend or revoke NFA's charter under the Act, hardly a realistic alternative, or to engage in a rulemaking itself to fill the regulatory gap.

Industry participants must belong to NFA if they want to do business with the public. Congress has authorized, and the Commission has approved, reposing this concentration of power in a private organization such as NFA only because the Commission is authorized to check abuses of that authority or deviations from the minimum standards that have been established by Congress and the Commission. It is true that unlike the exchanges, which have a proprietary purpose, NFA exists solely for the purposes of self-regulation. NFA is nonetheless a mandatory membership organization, with a Board of Directors composed almost entirely of industry representatives. Thus, it is not inconceivable that there may arise instances of disagreement between the Commission and NFA which can be resolved only by the Commission, as the oversight agency charged with the ultimate responsibility for ensuring compliance with the Act, exercising its authority to alter or supplement a given NFA rule.

The optimal solution would be for the Commission to be able to make alterations to a questionable NFA rule, without doing irreparable harm to the concept of self-regulation.

Question 2. Your prepared text mentions CFTC's adoption of rules to achieve effective trade reconstruction—the so-called audit trail. Some people are concerned that the CFTC's rule will result in burdensome paperwork for traders and give rise to a slower execution of trades. If so, the liquidity available in futures markets could be reduced. Is the CFTC willing to consider alternative means of construction of audit trail?

Answer. The concern that the Commission's new audit trail rule mandates greater paperwork for traders is not warranted. In fact, the Commission specifically deleted from its regulations the requirement that brokers and traders in the pit record the time of execution on their trading cards in order to accommodate a wide range of audit trail systems in which a member may not have to record a time. Thus, the Commission's present rule permits a variety of alternatives for meeting the standard in the rule, some of which have little or no effect on paperwork or speed of execution.

Question 3. How many transactions per minute does a busy broker execute in active market (such as the CME's S&P stock index or the CBT's Treasury bond)?

Answer. The number of transactions per minute of a busy broker in an active market is difficult to quantify without an extensive and expensive review of the underlying trade records, including order cards and trading tickets. However, according to trade data from the CBT soybean pit for a period of active trading, in the busy opening thirty-minute bracket period the highest average number of trades per minute was six trades per minute, by only one broker out of 272. The average number of trades by all brokers in that same pit for the same time period was less than one trade per minute per broker. The frequency of six trades per minute for the one broker may itself be overstated if either or both of the following examples occurred:

(1) If the trader put on spread trades, the CBT data base would indicate two transactions, when only one transaction is executed at the spread differential to accomplish the taking of the position, and

(2) If the trader were to have filled a 100-lot order opposite someone with ten ten-lot orders, a single transaction would appear in the data base as multiple transactions (ten in this case).

Thus, without the actual underlying documents, it is impossible to say absolutely the number of transactions typically executed by a busy trader.

Question 4. How many times does the selling broker make an offer before a sale?

Question 5. How many times does a buying broker make a bid before a purchase?

Answer. Because of the numerous variables and expectations surrounding the process it is impossible to ascertain a representative number of bids or offers before a trade is executed with any accuracy. Some of these factors include the pace of the market at the particular time the bid or offer is made, whether the bid or offer is made on the open or close, and the type of order, just to name a few.

Question 6. What would the consequences for the customer be if the broker kept his head down?

Answer. Eye contact and observation of activity in a pit are essential to successul futures trading. However, dropping one's eyes for some seconds to record essential trade data at present does not interfere with execution of customer orders or personal trades. The essential trade data recorded for each trade prior to the Commission's new rule includes opposite broker, price, quantity, contract month, and in the case of an option, the strike price, a total of approximately ten charactors for future trades and more for options. It takes approximately five seconds or less to write down such essential trade data.

Question 7. Since the exchanges have proposed to adopt a sequenced record of trading for each floor trader for his own account, won't that resolve the enforcement issue you raised regarding intra day specultative position limits?

Answer. Whether the CBT-CME audit trail proposal, which includes the sequencing of trading cards involving personal trades, will resolve instances of suspected intra-day speculation limit violations will depend upon how that proposal finally is implemented. While it appears that this proposed system would have the ability to resolve questions regarding whether the speculative limit was exceeded within a thirty-minute bracket period, the Commission will not be able to make a final determination in this regard until the details of the proposed system are spelled out more precisely.

Question 8. Is there a particular customer abuse which the Chicago Mercantile Exchange and Chicago Board of Trade proposed audit trail system would be incapable of detecting?

Answer. The Exchanges represent that their system will detect the full range of rule violations relating to customer orders, intra-day manipulation, and speculative limit violations. The effectiveness of this system to detect these kinds of abuses, of course, will become evident as the systems are further developed and implemented.

Senator LUGAR. The Chair would like to call now Robert K. Wilmouth, president of the National Futures Association, Chicago, IL.

Bob, it is good to have you here today. If you could try to limit your testimony to 7 minutes, that would be helpful and, by unanimous consent, both your oral testimony and the additional presentation you make will be a part of the record.[1]

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[1] See p. 210 for the prepared statement of Mr. Wilmouth.

STATEMENT OF ROBERT K. WILMOUTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

Mr. WILMOUTH. Thank you, Senator, very much.

I am Robert K. Wilmouth, president of National Futures Association, the self-regulatory organization for the Nation's futures industry.

Four years ago, when I appeared before this committee, I had no way of knowing that I would shortly be called on to help build NFA into a powerful regulatory force. Yet, I joined with many others in this industry in affirming that it could be accomplished, and that given the chance it would be accomplished. You gave us that chance, and you wisely asked that, after 3 years, we account for ourselves with a report on our performance. A full text of that report, entitled "The First Three Years," has been furnished to the committee and the staff.

Before addressing the specific legislative recommendations which the CFTC has submitted to the committee, allow me to briefly bring you up to date on a few of the highlights of NFA's first 3 years, highlights which clearly confirm that NFA is a promise fulfilled.

NFA has fulfilled its promise to relieve the CFTC of the burdens and costs of direct regulation. As a result, the CFTC has been able to utilize its available resources more effectively in connection with its oversight responsibilities.

NFA has fulfilled its promise to fill what were then regulatory gaps. Specifically with respect to nonexchange member futures professionals. By extending a guiding hand, we feel we have had a tremendous impact on voluntary compliance.

At the same time, NFA has also fulfilled its promise to apply a firm hand when and where needed. Where the public trust has been abused, we have the power to be firm, the resolve to be firm, and an impressive record of being firm. We strive to be fair. We do not strive to be gentle.

NFA has fulfilled its promise to extend the battle against unethical sales practices beyond the bounds of the legitimate futures industry, to slam the door on regulatory safe havens for the unscrupulous. A case in point has been our efforts to assist the North American Securities Administrators Association in drafting and enacting a model State commodity code, putting flesh on the bones of the "open season" provisions which you enacted in 1982. Another example has been our aggressive, highly successful educational effort, a coordinated nationwide campaign against commodity fraud.

NFA has fulfilled its promise to promote observance of high standards of ethical conduct. Just as the enforcement of our rules has been tough, so have the rules themselves, rules made by the industry having to do with the handling of discretionary accounts, with advertising, with fee disclosure, and with "know your customer" requirements, to mention but a few.

NFA has fulfilled its promise to strive for ever higher standards of knowledge and proficiency in the futures industry.

NFA has fulfilled its promise to take over the CFTC's arduous registration tasks, doing virtually everything the CFTC was doing plus registering introducing brokers, the fastest growing industry sector, plus issuing temporary licenses to all eligible associated persons.

NFA has fulfilled its promise to avoid becoming a duplicative regulatory layer. We have worked closely and continuously with exchanges not only to prevent overlap but to harmonize existing compliance requirements.

NFA has fulfilled its promise to provide a system for fast and fair resolution of customer claims against futures professionals. Our highly successful arbitration program has over 1,000 volunteer arbitrators in 47 States.

NFA has fulfilled its promise to be efficient and to promote efficiency. Example: Reducing the number of separate registration forms that many brokerage employees had to file. Example: More audits and thorough audits in relation to the size of our audit staff. Example: An arbitration program that handles as many filings as CFTC reparations. Example: Creation of state-of-the-art data processing capability to speed registration, and automate complex financial audit and surveillance functions.

NFA has fulfilled its promise to avail itself of the best and brightests talents from both within and without the futures industry. It is simple: Good people do good work. We do have good people, experienced, well-trained, and they do indeed do good work. More importantly, in addition to these staff capabilities, we are fortunate in being able to tap the valuable talents, expertise, and energies without cost of the members of all of our committees, governing bodies, and arbitration panels, former CFTC Commissioners, current and former exchange chairmen and presidents, brokerage firms CEO's, former CFTC staff, and so on.

Finally, and perhaps most importantly, NFA has achieved its promise and ambitious goals without spending a single penny of taxpayer money. As an entirely self-financed body, NFA has clearly demonstrated the continued willingness of the futures industry to bear its fair share of the cost of regulation.

Not only has NFA achieved its goals without spending a cent of taxpayer money, it has saved taxpayers over the course of 3 years in excess of $35 million, $35 million it otherwise could have cost the CFTC to perform those functions now being performed by NFA.

It is an organization that has done its job, that remains dedicated to doing its job, and determined to do it well.

Let me now share with you some of our views very briefly on several CFTC legislative proposals, which I fear, if enacted, could significantly impact our ability to do our job well.

Two of them we support. Two we do not support.

We fully concur with the proposal to amend, to plug what amounts to a loophole in section 17(h) of the act. As now worded, any NFA member that is the subject of an NFA disciplinary action can automatically stay that action simply by filing a piece of paper with the CFTC. This provision unintentionally undercuts NFA's ability to protect customers in emergency situations. The CFTC proposes that the granting of the stay should be discretionary. We agree.

We also favor the proposed amendment which offers certain refinements to the CFTC process of reviewing NFA actions.

There are, however, two other proposals that we oppose. The first of these, an amendment to section 17(j), would delete the present requirement that the Commission act on NFA rule proposals within 30 days unless a longer period of time is requested. We believe that whatever minimal incentive the current statute provides for timely consideration of NFA rule proposals should not be eliminated.

A fourth proposed amendment to the act has to do with section 17(k)(2). If approved, and we certainly hope it will not be, it would give the Commission virtually complete authority to alter or supplement and, in essence, to write NFA rules. This proposal is both unnecessary and unwise.

I ask you why now? In 1974, 1978, and again in 1982, Congress closely examined the still untested NFA. At no time did the Congress or the CFTC see any need for the power the CFTC now seeks. One might assume this power is now being sought as a remedial matter in response to failure of NFA to make tough decisions on tough issues. Such has not been the case. Quite the opposite.

On a "know your customer" rule, NFA acted.

On acceptable content for advertising and solicitations, NFA acted.

On proficiency testing, NFA acted.

On disclosure of fees, on an experience requirement for discretionary trading, on stringent supervisory requirements, on all of these and on other very tough issues, NFA acted responsibly, decisively, and effectively.

It happened because we have a rule-development process that works, a process that owes its efficacy to NFA members, staff, and governing bodies that carefully consider, closely scrutinize, painstakingly dissect, and laboriously redraft and refine every appropriate rule addition.

Under current law, the CFTC must approve NFA rules which are consistent with the requirements of the act. Within that standard, NFA is permitted to exercise its informed judgment.

The key question, I suggest, is What would happen if, as proposed, the Commission could substitute its judgment for NFA's simply by threatening to exercise an "amendatory veto." The answer is clear. There would be no incentive to even discuss, much less tackle, solutions to tough ethical questions. Not if there is a real possibility that the solution will be freely rewritten.

The current proposal rewards the exemplary performance of NFA's members by undercutting their authority, by substituting Government regulation for self-regulation, by transforming a cooperative process into an adversarial process, by threatening to make NFA no more than the CFTC's Division of Self-Regulation. It does not make sense.

Nor do the CFTC's stated reasons for proposing it. The argument that it should have this authority over NFA because it has similar authority over exchanges places symmetry above substance. NFA is not a contract market. Its interests are different. Its level of congressional guidance is different.

The Commission also argues that certain anomalies result from its lack of authority to rewrite NFA rules. They are not anomalies, they are mirages, perceived problems that do not exist. For example, it is powerless, it contends it is powerless to require NFA to alter its financial requirements. Not so. It can require us to alter ours merely by altering its own. Similarly, wherever the CFTC feels NFA ethical guidelines are inadequate, it already has authority to remedy any perceived shortcomings through its own rulemaking process. This is a far more appropriate way of dealing with such issues than the authority now being sought.

In sum, this proposal does not merely try to fix something which is not broken; it threatens to break something that is working extraordinarily well.

Allow me to conclude my remarks by noting that on each of the previous three occasions that you have taken a close look at the structure of futures trading, you have made one consistent point. You wanted NFA.

In 1974, NFA was no more than an idea.

In 1978, it was brought into sharper focus.

In 1982, it became not only a goal of the Congress, but a promise by the futures industry.

We asked for the chance to regulate ourselves.

You gave us that chance.

We believe your expectations have been met and perhaps exceeded, and that the promise has been fulfilled.

We believe, too, that self-regulation holds still greater promise, and we look forward to its fulfillment.

Thank you.

Senator McCONNELL [presiding]. Thank you, Mr. Wilmouth.

Has NFA taken over any of CFTC's registration functions since the enactment of the 1982 amendments?

Mr. WILMOUTH. Yes, Senator. We have taken over all of their functions with respect to futures registration except for floor brokers. They still have the power to oversee what we do and there is still an appeal authority to the Commission. But essentially we do everything in the registration area that they did before.

Senator McCONNELL. What additional functions could you assume if budget cutbacks affecting the Commission materializes?

Mr. WILMOUTH. Well, there is nothing left in the registration area except for the category of floor brokers which is under consideration. We do all of the audits of the nonexchange member FCM's and the exchanges do the rest of them. We do all the audits of CPO's and CTA's and introducing brokers, which is quite substantial. The CFTC merely oversees what we do from time to time.

I am not certain that I see any specific area of responsibility that we could take over. I will say this though, we are a self-regulatory body and, as such, voluntariness is important to our organization. Our members belong to the organization and voluntarily perform the tasks that are necessary. There is no other registered futures associations, but if there were another one, they could voluntarily join that one. They must belong to one.

But I would say that any responsibilities which the CFTC felt were necessary to pass on to a self-regulatory body, be it the exchanges themselves or National Futures Association, we would certainly take a look at anything that came our way and bring it before our board of directors for their consideration.

But I want to emphasize that it should be voluntary because that is what makes our organization tick and work.

Senator McConnell. CFTC has asked for authority to review and alter NFA rules. Do you favor such an approach, or will this new authoiity adversely affect the NFA in performing its responsibilities if it were granted?

Mr. Wilmouth. We are unalterably opposed to that proposal. It is the proposal that I most strongly oppose that they have put forward with respect to National Futures Association.

Quite frankly, it could kill us. Our organization works through the voluntary efforts of our members who go to, for example, FCM advisory committee meetings, devise a rule on advertizing, devise a rule on solicitation, devise a rule on fee disclosure. We push that rule from the FCM advisory committee to our executive committee to our board of directors, and then to the CFTC for approval. We have voluntarily done every single thing that has been asked of us. And we have, in my opinion at least, done it in a timely manner. We have done it because we have hundreds of members who are willing to give thousands of man-hours devoting themselves to helping write rules, which the CFTC has the power to oversee anyway. We have to meet the minimum standards that the CFTC sets. If we do not, they don't have to approve our rules. Also, they can change their standards so they automatically really have the authority they seek now. There is absolutely no need for them to call for this new authority.

Senator McConnell. How do you obtain your operating budget?

Mr. Wilmouth. We obtain our operating budget entirely from our members. Really two sources. Dues which come in from our members and then an assessment fee which, at this time, amounts to 28 cents per round turn.

NFA is entirely self-financed by the industry itself, not utilizing one iota of taxpayer money. And that totaled over $35 million in our first 3 years of existence.

Senator McConnell. Have the fees changed since 1982?

Mr. Wilmouth. Yes, sir. They have changed once. They started out at 33 cents and then went down to 28 cents, and have been that for approximately 2 years.

Senator McConnell. NFA has expressed some reluctance to register and otherwise assist in the regulation of leverage transaction emergence.

Is this true and, if so, what is the reason for the reluctance?

Mr. Wilmouth. I would not say, Senator, we have expressed a reluctance. I have merely pointed out on other occasions with respect to this organization, and again I repeat that we are a voluntary organization, that we cannot do anything really effectively unless our members really want to do it and want to take on that responsibility. We have taken on everything requested with respect to futures. If, for example, there was some need to bring to our attention the fact that we should regulate leverage transactions, we would certainly discuss it with the board of directors. And again if we voluntarily agreed that that was the thing to do, then we would take on that responsibility.

Senator McCONNELL. The Commission suggested as an alternative for the repeal for section 19 that a moratorium could be lifted provided that the NFA assumed a role in regulating the expanded industry.

Does NFA have the ability or resources?

Mr. WILMOUTH. Well, we have a full slate on our agenda right now, but subject to any new requirements that come our way and that we feel—that our board of directors feel we could take on, then we would certainly take a look at it.

Senator McCONNELL. Senator Zorinsky.

Senator ZORINSKY. I have no questions.

Senator McCONNELL. Senator Melcher.

Senator MELCHER. I have no questions.

Senator McCONNELL. Senator Harkin.

Senator HARKIN. Thank you, Mr. Chairman.

Good to see you again, Mr. Wilmouth.

Mr. WILMOUTH. Thank you, sir.

Senator HARKIN. I was on the House side the last time I think——

Mr. WILMOUTH. That is correct.

Senator HARKIN [continuing]. That you testified before Ed Jones' subcommittee in which I served about 10 years.

I just want to hear one more time, and I am trying to read your testimony and compare that with the testimony with Ms. Phillips who was just here. I apologize for being here a little late.

But the alteration in the section dealing with 17(k), as I understand it, what the Commission is saying is that they just want to make the rule under 17(k) basically the same as what the rule will be for the rules that they have covering the markets themselves, the exchanges. They are saying that they have, as the results of these anomalies, where they can present prior alterations in exchanges. But that they could not require the same be done under NFA rules. It was where they could tell exchanges, and the NFA would say something else, and you would have a conflict there.

Tell me more about that. Is that a real conflict?

Mr. WILMOUTH. It is a mirage, it's a total mirage.

They perceive a problem where there is no problem.

Let me point out two reasons why we are so strongly opposed to this rule, and it is the one that gives us great concern.

I think, first of all, that they are trying to compare us to an exchange. We are not an exchange. The interests of our members are entirely different from those of the exchanges. We are not a contract market. We do not write contracts or have big economic staffs to study contracts. We do not have anything to do with the exchanges, and we do not operate like they do in any way. We have one job, and one job only, and that is protecting the public that participates in the futures market. That is our job.

For 3 years, unstintingly, we have done that job through the voluntary cooperation of our members on our various committees. For the CFTC to say that it is powerless to require us to alter our financial requirements just is not true as far as I am concerned.

It can require us to alter ours by merely altering its own since we must live up to the minimum standards which it sets. That is all it has to do. I can see no reason for it not having that right.

What I am afraid of, if the CFTC has this amendatory veto, then what is going to happen is I am going to call on five or six of our members and ask them to serve on the FCM advisory committee, and they are going to look at me and shrug their shoulders and say "What for, when the CTFC is just going to turn around and rewrite our rules, supplement them or alter them. I am not going to spend any time with you."

The organization then falls apart. Where we have an extremely powerful regulatory tool to protect the consumer, we lose it. There is no reason for us to lose it because the CTFC has the right to alter our rules, our financial rules now, by merely altering its own. We must meet those minimum standards. There is no reason for additional authority. I really do not understand it.

Senator HARKIN. I have read both testimonies and I have heard you talk about it. It just seems like what they are saying is that they just do not want to. I do not know that it has ever happened in the past. They would see the rules and a change in the procedures of an exchange, and the NFA would have a different type of a rule. I have not seen that yet.

Mr. WILMOUTH. You will not. We have not seen it. And, in fact, in the entire history that I can go back, and I go back a little bit less than 10 years in the industry, to the best of my knowledge, they have seldom used it. They do not have the authority to use it with us. And that is what they are seeking.

But in the history of the exchanges, to the best of my knowledge, they have used it on three times specifically. Two times it related to contract market terms, with which we have nothing to do. I do not remember what the other time was.

But I am afraid what they can use it for is a club over your head. "If you do not write that rule just exactly the way we want you to write it, then we are going to force you to write it this way." And in a voluntary organization, that does not work. Throw in the towel.

Senator HARKIN. Mr. Chairman, is there anyone here from the CFTC that could enlighten me, not perhaps during the hearing, but later on I would ask them to do so on this. They have a different opinion than this.

I tend to think that Mr. Wilmouth is right. If I had some instances of where we had these kinds of things that had come up, especially in front of the public, then I would be more inclined to go with the CFTC's recommendation on this. But I have not seen any indication of that.

Mr. WILMOUTH. The CFTC has not. It has approved all of our rules, although we have had some discussions about the contents of them, and I am sure we will continue to do so.

Senator HARKIN. I was not in the discussion earlier on the audit trail problem which came up. Do they become somewhat involved?

Mr. WILMOUTH. Well, NFA has nothing to do with the exchanges. In fact, NFA stops before you go in the front door of the exchanges. But I would——

Senator HARKIN. You have a lot of background in that?

Mr. WILMOUTH. Yes, I do, and if I may make a personal observation, a comment.

I would say that I am concerned in two different areas. First of all, I am concerned about what could happen if the wrong type of a implementation process comes along. It could impact liquidity very seriously, and that is what the markets are all about. We have very liquid markets now. That is what makes them work.

It could also impact the cost of a transaction which again is a threat to the public somewhere along the same line as liquidity. I have that concern.

The other concern I have is, in addition to impacting liquidity and operational costs, which could effectively destroy the markets, it seems to me from my observation that of the proposals that have been put forward by the two largest exchanges, the Chicago Board of Trade and Chicago Mercantile Exchange, have merit. I have seen in both of those proposals from my background, admittedly having been away from the exchange for almost 4 years, definite merit in adopting portions or all of those put together. However, I have not put them together in my own mind.

But it seems to me that both the Chicago Board of Trade and the Chicago Mercantile Exchange in particular have put forward proposals which, to my way of thinking, do as good, if not a better job in attempting to obtain the same type of information that the CFTC wants.

Both exchanges, I know from my past experience with the board of trade and close association with the mercantile exchange, are definitely interested in better audit trails. Both of them have come up with different, but in some respects similar, types of proposals which will solve the problem, at least to the best of my knowledge. I think, by working with those two proposals they have already attempted to accomplish that. I think they have the makings of something that will work, and they will be able to come forward with a solution which will still keep the liquidity in the markets and still keep the costs reasonable. Otherwise, you can destroy the markets.

I think the makings are there between the Chicago Board of Trade and the Chicago Mercantile Exchange to do that job. If they do not, if they are forced to adopt some type of a proposal that does not make any sense, then you have got a marketplace that is impaired, not only from a cost standpoint but, more importantly, from a liquidity standpoint. You have got a market that is not going to work well.

Senator HARKIN. Thank you very much.

Senator MCCONNELL. Mr. Wilmouth, let us wrap it up with a couple of questions that Senator Helms would like you to respond to.

Has the National Futures Association taken a position on the Commission's proposal to cease regulation of leverage transaction merchants? If so, what is it? If not, do you anticipate taking a position?

Mr. WILMOUTH. No, sir, we have not taken a position on leverage transactions, and unless something is brought to the attention of our board of directors with respect to it, I would not anticipate us taking a specific position.

Senator McCONNELL. If the Commission's proposal on leverage is not adopted, does the NFA wish to admit leverage transaction merchants to membership and to regulate their activities?

Mr. WILMOUTH. Only if the voluntary organization I represent feels that it is appropriate for it to take on that responsibility. We certainly have the capability to do it, not necessarily the capacity, but the capability. But that would have to be a decision that would have to be brought to the attention of our board, Senator.

Senator McCONNELL. Thank you.

Senator Leahy, we are about to let Mr. Wilmouth go. Do you have any questions?

Senator LEAHY. Mr. Chairman, I have an opening statement that I will submit for the record. I may also have some questions for Mr. Wilmouth, and I will submit those for the record.[1]

I have known Bob Wilmouth from the time we had the first reauthorization of the CFTC. I consider him one of the most knowledgeable people in this area. I think we are fortunate to have him testify here today. In fact, as I look down through the list of people testifying, I am struck by the fact that they have more collective experience and knowledge in this area than any group we could assemble. In particular, I think this industry is fortunate to have a man of Bob Wilmouth's caliber here.

I will submit my questions for the record.

Senator McCONNELL. Thank you, Senator Leahy.

Thank you, Mr. Wilmouth.

[The written questions from Senator Leahy and Mr. Wilmouth's answers thereto follow:]

Question. The CFTC is requesting expanded jurisdiction over off-exchange operations. In your view, what is the appropriate role for CFTC in monitoring off-exchange activities?

What efforts has NFA undertaken in this regard?

What do you believe to be an appropriate role for State regulators in monitoring off-exchange activities?

Answer. The CFTC's proposal is to amend Section 4b of the Act to clarify that the anti-fraud provisions of that Section apply to illegal off-exchange activities as well as to activities concerning exchange-traded futures. (This is not actually an expansion of the CFTC's jurisdiction over illegal off-exchange products, as Section 4(a) already prohibits off-exchange futures trading.) The purpose of the proposed amendment is to strengthen the CFTC's enforcement powers by allowing the CFTC to charge operators of fraudulent off-exchange schemes not only with trading futures illegally, but with fraud as well.

NFA strongly supports a vigorous enforcement program, at both federal and state levels, against illegal off-exchange activities. NFA participates in an enforcement referral program with the States, the CFTC, the SEC and the NASD, whereby questionable advertising, activity by unregistered persons and customer complaints relating to non-NFA Members are referred to the proper organization for review. In its first three years of operations, NFA made 566 such referrals. NFA maintains a close liaison relationship with the CFTC and has worked to create an effective liaison with other federal and state agencies through the umbrella network of the North American Securities Administrators Association ("NASAA"). In addition to its general liaison activities, NFA has been involved in numerous specific projects, such as:

Providing direct technical assistance on specific ongoing matters to state and local authorities.

Assisting the NASAA Special Projects Committee in targeting for investigations certain off-exchange precious metals dealers to determine the existence of possible law violations.

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[1] See p. 165 for the prepared statement of Senator Leahy.

Helping to draft NASAA's Model State Commodity Code, actively encouraging the introduction of such legislation in every state, and testifying in support of such legislation before state legislatures.

The adoption of the Model State Code will, NFA believes, allow state regulators to take advantage of the "open season" provision of Section 12(e) of the Act. This provision allows states to use state law as a weapon against illegal off-exchange activity and persons and firms who are required by the Act to be registered but are not so registered. In addition, under Section 6d of the Act state regulators can bring actions to enforce the Act in federal or state courts. NFA will continue to use its expertise to assist in the bringing of such actions. NFA believes that effective enforcement action against illegal off-exchange operations requires the efforts of both the CFTC and the States and thus NFA's liaison efforts are directed to that end.

Question. In your prepared text, you note several instances in which NFA acted to address tough issues facing the futures industry. Evidentally, NFA handled these difficult issues to nearly everyone's satisfaction. Why do you believe that CFTC—if granted authority to alter or supplement NFA rules—would use that broader authority to undercut NFA's authority?

Answer. The CFTC's proposed amendment to Section 17(k)(2) of the Act would undercut NFA's rule making authority and threaten the effectiveness of NFA's rule making process in several ways. Under current law the Commission *must* approve NFA rules which are consistent with the Act. Within that standard NFA Members have the freedom to exercise their own judgment and have the assurance that the ethical guidelines they must follow are ones they develop themselves. This freedom and this assurance have been strong incentives to tackle tough issues which had been left unaddressed for too long. The present system works.

The CFTC proposal replaces freedom with coercion, assurance with suspicion and incentives with disincentives. NFA Members can hardly be expected to even initiate discussion of tough ethical issues when the results of their efforts can be so drastically altered by the CFTC.

NFA's concerns about the chilling effect the current proposal would have on NFA's rule making process are based on more than pure conjecture. Though the Commission has made limited direct use of its power to rewrite contract market rules, it has, based on NFA's discussions with various contract markets, frequently used its power indirectly, requiring exchanges to rewrite rules to avoid the CFTC's direct use of its power. The threatened use of such power would produce the same negative impact on NFA's rule making process as its actual use. It will destroy the current incentive for effective self-regulation and retard the overall cause of customer protection.

Question. Can NFA regulate leverage transactions? In your view, is NFA or CFTC the appropriate regulatory organization to oversee leverage transaction?

Answer. NFA was formed by the futures industry with a mandate to protect futures customers through effective and efficient self-regulation paid for by the futures industry. NFA's mandate does not include regulation of leverage transactions. However, NFA has the potential to regulate leverage transactions if it chooses to do so and if the task were reasonably defined. Regulation of leverage merchants in the areas of net capital, handling of customer funds, recordkeeping and sales practices would not generally be different in kind from what NFA does now; there may be some special auditing problems but these would not be insurmountable. Of course, the question of how NFA would recover the cost would also have to be addressed.

But just because NFA could regulate leverage does not mean that it should do so. There are many things NFA could do which in the aggregate might tend to divert NFA from its primary mandate. It would be up to NFA's Board of Directors, which is a large and diverse body representing every facet of the futures industry, to decide whether to expand the definition of instruments subject to NFA regulation. Such a decision would be made after considering the best interests of the public and the Membership.

The CFTC's legislative proposal is to delete Section 19 and other provisions so that leverage is essentially excluded from regulation under the Act. In discussing alternatives to this approach, the CFTC has noted that lifting the existing leverage moratoria and continuing to regulate leverage under the Act would add to the ever-increasing demands on the Commission's resources. It appears, therefore, that the CFTC has a concern similar to NFA's about the appropriateness of an organization funded to regulate futures taking on the burden of regulating leverage. In the event that Congress decides to either maintain the current level of regulation under the Act or to lift the restrictions and mandate regulation of an expanded leverage industry under the Act, NFA believes that the CFTC should continue to play a role in such federal regulation.

Question. Some controversy has arisen concerning rules designed to facilitate construction of the "audit trail" (reconstruction of trades). What do you believe is the most efficient means of such market surveillance?

Answer. NFA has no role in the "audit trail" issue. NFA has always been organized to deal with customer protection issues from the exchange doors outward and has no role in internal contract market affairs.

However, from my personal perspective as an industry participant over the last ten years, I can make several observations. First, the contract markets have always done what is necessary to maintain the traditionally high level of public confidence in the futures markets. Second, I believe that trade reconstruction cannot be purchased at the price of market liquidity or efficiency. Third, it is my understanding that the systems for trade reconstruction currently proposed by the Chicago Board of Trade and the Chicago Mercantile Exchange have the capability to accomplish the fundamental surveillance purpose of interest to both the exchanges and the CFTC.

Senator McCONNELL. The next witnesses appear as a panel: Leo Melamed, chairman of the executive committee and special counsel to the board of the Chicago Mercantile Exchange; John F. Gilmore, Jr., chairman of the Chicago Board of Trade; Alan J. Brody, president of the Commodity Exchange of New York.

Go right ahead.

STATEMENT OF LEO MELAMED, CHAIRMAN, EXECUTIVE COMMITTEE, AND SPECIAL COUNSEL TO THE BOARD, CHICAGO MERCANTILE EXCHANGE, CHICAGO, IL, ACCOMPANIED BY WILLIAM BRODSKY, PRESIDENT

Mr. MELAMED. Mr. Chairman, distinguished panel, my name is Leo Melamed. I am special counsel to the board of the Chicago Mercantile Exchange and chairman of its executive committee. Accompanying me is our president, Mr. William J. Brodsky.[1]

As most of you know, I have been involved with the futures industy for over 15 years. During this period I have participated in bringing this industry to the forefront of markets worldwide. Indeed, I led and presided in spawning a whole array of new techniques and new markets which brought our industry from one that was small and solely agriculturally based to one that is of international stature, trading nearly 150 million contracts last year alone.

At the Chicago Mercantile Exchange, we have also succeeded over this time period in revolutionizing the concept of futures trading. We brought futures into the modern world, and as a result the transaction volume at our exchange rose from approximately 3.3 million contracts in 1970 to 56.5 million contracts last year, an increase of over 1,600 percent. And, Mr. Chairman, there are not many commercial institutions or industries that can boast of this kind of success over this same time period.

I might add that in bringing the futures industry to an international stance, we have brought in approximately one-third of the business from international sources. This favorably affects the balance of payments to the United States to the tune of approximately $1 billion per night. This money is held as margin deposits at banks on behalf of the exchanges.

Today, our agricultural and financial contracts are an integral marketing tool for transferring risk, one without which the industries we serve would be hard pressed to survive; and ones that the

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[1] See p. 215 for the prepared statement of Mr. Melamed.

Federal Reserve and many other Federal agencies have confirmed as serving an important and useful function.

Having brought our industry to the cutting edge of market science, I am sometimes amazed at the views expressed by our regulators which indicate that we seem to be an antiquated industry; one that can hardly manage to truck along in this modern society of ours. The fact is, sir, that we have done everything to bring ourselves to the cutting edge of technology and in many, many instances have succeeded in bringing along the rest of our world, including the securities industry.

I cite these credentials, sir, not to boast, but to indicate that the complaints I am about to launch against our regulators come from a qualified source, one experienced in matters of which we speak.

Sir, I am afraid to say and to testify that unless our complaints at these hearings are addressed by this panel and this Congress, we in the industry fear for our future. We fear for the sanctity of these markets; we fear for their liquidity base; we fear for the costs that may have to be passed on directly or indirectly to the hedgers and consumers that utilize our markets and for whom these markets are instituted and serve. We fear for the costs that may be passed on to the FCM community that services our customer base. And we fear for the process itself which will be slowed down, both in execution and confirmation of trades and burdened unnecessarily.

I speak, sir, of things we know. We have been in this business creating new markets before some of the regulators knew that future is sometimes spelled with an "s" at the end. And I am here to tell you that we are every bit as concerned about many of the same issues as the CFTC. The only difference between us lies in the solution. We think we know how to do it, and our records indicate we know how to do it.

Allow me to give you some examples of some of the differences of opinion between the industry and our regulators.

The one area you heard somewhat about already this morning is the area of audit trail. Audit trail is something that the CFTC did not invent. Audit trail is something that the industry would like to have. The integrity, sanctity, and trust in the transaction process of our markets is more important to us than anything else. And indeed if one were to look at the growth of our industry, we could handily say that there is a trust out there and that we have done this job pretty well.

Anyone visiting our trading floors for even a moment would instantly recognize that the transaction process is based on the rapidity of order execution, the bids and offers that flow through our market, and the transaction process that has to occur in a most rapid form because prices are subject to change.

The brokers of our markets are independent contractors. If, as a result of their execution process they are in error or negligent, they must make it good with their own money from their own pocket. They already have much information which must be recorded on the order they executed. They cannot wait too long because the next order is directly behind, on its way into the pit. If they do not execute the next order, they will be responsible and it will be their money that will be at stake. They do very, very well—

they record the opposite broker; they record the bracket in which it was executed; they record the price, the amount, the opposite clearing firm involved. The order has already been time-stamped at the time of entry, and will again be time-stamped when it returns to the order desk.

Some of the orders enter the pit by virtue of a flash signal from a clerk at the desk. That order enters the pit within 10 seconds from the time it is received by that clerk. If it is a market order, it is probably returned to him with an execution price within another 10 or 20 seconds. That same broker is by this time executing another order.

If we were to do as the CFTC suggests we would unnecessarily burden that broker to create an audit trail; but, in doing so we would create an audit trail that would reduce the viability of these markets and the function for which they exist. We cannot in good conscience agree with our regulator that this is what is needed for an audit trail. Indeed, our expertise has provided for them an answer, an answer that we think is more than adequate. We think it is reasonable and one that pays attention to the cost benefit of the system involved. The cost benefit, Mr. Chairman, is the most important thing that we think ought to be attended to in creating any new system of procedure or transaction on our floor. And the cost benefit of this process is what we are here to address.

We want an adequate audit trail. We certainly do. But we do not want it to be at such a cost that the system would be impaired.

We offered a computerized data base of information, inclusive of a sequence time window with respect to every public order sufficient to prevent and detect abuses. We think that is a very adequate audit system.

We and the Chicago Board of Trade jointly developed this system and offered it to the CFTC. It has not been accepted because the CFTC would prefer to blindly insist upon a regulation that makes no sense, one called 1-minute time stamping that cannot be instituted in this system without enormous costs and one which is unnecessary to achieve an adequate audit trail. Audit trail must be achieved in a way that it is compatible with the free market system, with the process we know best, and one that we think will achieve the exact results that the CFTC and our industry are looking for.

In another area, as another example of CFTC action which was unwarranted, we cite the proposed capital rule recently promulgated and one in which the CFTC has now given us additional time to respond—but only after a hue and cry from our industry! The one they had originally proposed would have put out of business approximately 25 to 30 percent of our solidly established and safe clearing firms. That is no way to proceed with new rules on capital.

The CFTC did not spend sufficient time analyzing their own proposal which seemed to be a knee jerk reaction to the one failure in the industry, a member of a New York exchange known as Volume Investors. The CFTC's own investigation indicated that Volume Investors was a failure as a result of its refusal to follow its own regulations. It was an exception, we believe, and the CFTC has also given us that indication. And an exception is not a reason to create a general rule that would disenfranchise so substantial a number of our FCM community.

The CFTC has seen the light, so to speak, and has given us additional time, but we fear that this kind of capricious action is not the way to proceed against an industry that has shown as much responsibility as we have in the past.

You just heard from a gentleman that spoke about the NFA, its president, Robert Wilmouth. He has indicated the kind of spirit within this industry and the type of service to government we perform in a voluntary and self-regulatory fashion. I presided in that process, sir, and am today chairman of the NFA, having been its founder chairman from the start, and having moved the industry to create a self-regulatory institution such as the NFA.

We believe that we are responsible citizens of the United States willing to carry our weight and pay for it. And we also believe that we are knowledgeable about our area of life.

I will give you one more example of our complaints, and I will submit the balance of my statement for the record, if you please.

The CFTC instituted a 3-year pilot program in options. That pilot program in options meant that the exchanges could introduce only a small number of additional options contracts. That program with its limitations and restrictions on our industry should have ended last October 1. The 3 years were up. But the CFTC did not end the restrictions. Those restrictions continue. And what do those restrictions mean? Several things.

For one, they mean that our competitors, which happen to be the SEC-regulated exchanges, can proceed in any direction and every direction to list new contracts as they please. And they have, taking our market share from us in markets that we invented, in markets that we launched and revolutionized. That is unfair.

We have no reason to believe that this program and its restrictions should have continued.

In agriculture, they affect this committee even more because the recent farm bill seems to indicate that Government wants the farm community to depend more upon the free market process and less upon Government. In order for the farm community to be able to depend upon the free market process—and we might say that we commiserate with their plight and their outlook is not bright—they deserve all the techniques of modern technology and markets in order to be able to sustain the coming years and the bad times yet ahead.

One of those tools is price assurance, made possible by the use of agricultural options. But, under the restricted CFTC program, we cannot list any more options. We have to go on a case-by-case basis and plead our case each time.

Recently, the National Cattlemen's Association implored that the CFTC allow feeder cattle options, so that the cattlemen can use this new tool to protect themselves from falling prices. We do not know whether the pilot program will be expanded to allow for that.

These examples illustrate the kinds of problems of which our industry is complaining, sir, and we look to this panel and its distinguished members to help and support us in this endeavor.

Allow me to finish by stating that we are living with an agency we feel is regulating often times for regulation sake. That is bad at any time. It is made worse under an administration that is asking our industry to self-regulate and simultaneously asking the Congress to deregulate. We certainly subscribe to that view. We certainly have shown our willingness to do so and have done it well.

Thank you.

Senator McConnell. Thank you, Mr. Melamed.

Your testimony was very effective, but I would like for you all to please to try to sum it up in 7 minutes, if you could.

Mr. Gilmore.

STATEMENT OF JOHN F. GILMORE, JR., CHAIRMAN, CHICAGO BOARD OF TRADE, CHICAGO, IL, ACCOMPANIED BY THOMAS R. DONOVAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER

Mr. Gilmore. I am John Gilmore, chairman of the Chicago Board of Trade, the world's oldest and largest futures exchange. Joining me today is Thomas R. Donovan, our president and chief executive officer.[1]

I was elected chairman only last month, but I have been an active participant in the commodity market for two decades. My first job after college was as a livestock analyst for E.F. Hutton & Co. Later I headed their futures operations in Chicago. I am now vice president of Goldman Sachs and head of their Chicago futures operations.

My roots in the commodity business go even deeper, however. My grandfather was one of the founders of Chicago's Union Stockyards. He and my father were livestock brokers. I am a commodity man through and through, and an unabashed champion of the exchange markets which grew to fulfill the needs of our growing Nation and which today are the envy of the entire world.

Mr. Chairman, during the past year, these great exchanges have been seriously threatened, threatened by a series of regulatory assaults, and an underlying regulatory mentality that all too often seems to ignore costs, exalt recordkeeping over market efficiency, and subordinate the vital needs of market users to bureaucratic whims.

It seems to be a grudge match between the CFTC Comissioners and staff and the Chicago exchanges. And why has the CFTC taken this route? We are told that our markets need more public confidence; that they need their confidence restored. Yet, in 1985, the Chicago Board of Trade traded 84 million contracts setting a new annual trading volume record for our exchange or any exchange. That is four times more than we traded 10 years ago. The facts speak for themselves. Public confidence in our markets has never been greater.

I have been cautioned that hearings such as this are generally regarded as ceremonial occasions where ordinary citizens can behave like statesmen and recite platitudes on the virtues of their regulators so as not to offend and, hopefully, to curry favor with those regulators.

I would like to, but I am not a statesman. I am a businessmen. I am a businessman whose business is seriously threatened by a Federal regulator. And the fact that men and women who constitute that regulator are sincere and well intentioned is no consolation when they force us to do things which are neither right nor just.

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[1] See p. 220 for the prepared statement of Mr. Gilmore.

Futures markets like Chicago's Board of Trade and Mercantile Exchange are among the things in America that work best. But the threat of overregulation now jeopardizes this American success story.

The Chicago Board of Trade and the Chicago Mercantile Exchange, the Nation's largest exchanges, account for 80 percent of the total trade. Recently we have been a target of disinformation of a major proportion. The issue is called better audit trails. The CFTC is for them, of course, and supposedly we are against them. The Commission is boldly moving into the 21st century. We are placed somewhere in the 19th century.

Motherhood, better audit trails, apple pie, what a trinity. Especially when you combine it with their so-called flexibility that allows us to be flexible enough to choose a method of our own demise. So let us get the record straight.

In the first place, what is an audit trail? An audit trail is the exchange's capability to reconstruct trading activity as a means to supplement market investigations. It is therefore an investigative tool, not an end in itself, not a record, but an investigative tool. The purpose is to ensure the honesty and integrity of all market participants.

So do we support better audit trails as an investigative tool? Of course we do. We always have and we always will. Indeed, we presently have an excellent, reliable audit trail for those who know how to use it. And we are committed to further improvements in that audit trail when technically possible,

Clearly, the best audit trail is one that combines state of the art technology and the know-how of the private sector. The best audit trail is one developed by people who trade on futures markets every day and who have a personal stake in preserving the markets' reputation and integrity. The best audit trail is one that will enhance our ability to investigate, while preserving our reason for being—providing liquid, efficient, low cost risk transfer and price discovery.

The Chicago Board of Trade and the Chicago Mercantile Exchange have created such an audit trail. We have submitted the joint system to the CFTC last week and presented the Commission with facts and figures supporting our system. To date, the CFTC has refused to signoff on our plan.

Frankly, we suspect they prefer a system where traders themselves record trade times with paper and pencil. That system is dependent upon a 19th century mentality that a card and pencil are better than technology and does not take into account market disruptions or costs.

Our system relies on the technology of the 21st century, computerization of detailed trade information from reliable sources. The CFTC adopts an unreliable, unimaginative and outmoded approach. It predates, in fact, the card and pencil and moves us backward to the year of the quill and inkpot.

All this began about 14 months ago when the CFTC proposed a fanciful mandate that envisioned our traders and brokers wearing some kind of an electronic wonder device which miraculously would time all trades.

Of course, the Commission did not do any advanced research but we were supposed to. We did. In fact, we hired four leading experts in the field, Dr. Merton Miller from the University of Chicago, Dr. Sanford J. Grossman from Princeton University conducted an economic study of the costs and benefits which they found to be expensive and ineffectual.

We hired a leading expert in trading systems technology and design. We retained another expert in time and motion studies. Both stated the Commission's report was wrong causing it technologically impossible.

We also went beyond merely studying this matter. While the experts found that the Board of Trade already had an excellent audit trail, based upon customer order time stamps, time and sales, and 30-minute brackets, the Board of Trade was still not satisfied. We wanted to build up our existing capability through computerization.

All of the expert studies were made available to the CFTC as we detailed proposed enhancements to our system. We even went to Washington to demonstrate a prototype of our system.

Months passed without any dialog whatsoever. Whatever the Commission was up to, we did not know. A web of secrecy existed. It seemed as though our proposition had fallen into a bureaucratic black hole to which there was no bottom.

And then, on a recent Friday afternoon, January 10, the Commission unveiled the final rule, with a 134-page staff document which left no room for discussion of what was a better audit trail.

Obviously, we requested a further opportunity for comment, in light of what we saw to be a doctored record and the fact that the text of the final audit trail rule differed so significantly from the original proposal, that we asked again that this not be the final rule. The Commission stated absolutely no.

Just 2 business days later, on January 14, they adopted the final rule. There was some great deal of misunderstanding here this morning on what the final rule was. I would like to read from their report the final rule:

Actual time of execution shall be stated in periods of no more than 1 minute.

That is the final rule. That is what we had to work inside of.

That literally seemed to mandate 1-minute trading with 100-percent accuracy and 100 percent of the time. One CFTC Commissioner, as well as the CFTC staff, readily acknowledged that no exchange could satisfy the literal mandate. The literal standard was impossible to meet in our fast paced public outcry markets where split-second timing is commonplace. They still, however, demand the impossible no matter what the cost.

Rather than throw up our hands or rush to court to litigate, we tried to further enhance our system. Along with the Chicago Mercantile Exchange, we sought a dialog with the Commodity Futures Trading Commission.

As my first act as chairman of the Chicago Board of Trade, President Donovan and myself came to Washington and sat down with the Chairman of the CFTC, and invited her to come to Chicago to have a presentation from the Chicago Board of Trade and the Mercantile Exchange regarding our audit trail system. Our staffs then came to Washington and gave the CFTC staff a 2-day factual demonstration of the system's capabilities. Despite these efforts, thus far the CFTC has not found itself willing to accept our proposal.

Let me assure this committee of one thing. The Chicago Board of Trade and the Chicago Mercantile Exchange are committed jointly to what will be the finest trade surveillance system available.

The system that these exchanges—and I will wrap this up quickly—the systems that we have put together formulate the significant development in the area of audit trails, a development that is not seen on any other exchange.

Chairman Phillips, this morning, gave the 1983 soybean example as a need for the audit trail. Please let me emphasize what this system will do the next morning. The system will the next morning tell you who traded, at what price, at what quantity, and when would be provided the next day. This is not the horse and buggy; this is star wars.

We have several other items that are on the CFTC's or our agenda during this year, and for the purposes of brevity, I would only like to mention one very important one.

We feel strongly that there should be no more than a 2-year reauthorization for the Commodity Futures Trading Commission. If we did not have this reauthorization process ongoing today, we have the final rule that I quoted before.

In conclusion, I am very grateful for having the opportunity to present my views. A great deal is at stake here. I know from personal and painful experience what excessive or misguided regulation can mean.

As I mentioned at the outset, my grandfather, Elinson Gilmore, helped found the Chicago Union Stockyards. As a young man alongside my father, I witnessed the slow death of that once great institution. In the last years, there were more regulators in attendance each day than there were people to regulate. No more, of course, not a single regulator remains or anyone else. The Chicago Stockyards is now warehouses and parking lots.

Yes, Mr. Chairman, there is a great deal at stake.

This concludes my remarks, and we request permission to supplement the record as needed

Senator McConnell. That will be done.

Senator Helms will be here in 15 minutes, and I must go. There are two Senators who are still here. Are you all going to be here for another 15 minutes?

Senator Zorinsky. I have been here for 2 hours.

Senator McConnell. I know you have.

Tom, are you going to be here for another 15 minutes? OK. Well, as long as there is a Senator here, would you gentlemen please proceed, and Senator Helms will be here at 10:45.

Mr. Brody.

STATEMENT OF ALAN J. BRODY, PRESIDENT, COMMODITY EXCHANGE, INC., NEW YORK, NY

Mr. BRODY. The presiding Mr. Chairman and members of the subcommittee, my name is Alan J. Brody, and I am president of the Commodity Exchange in New York, also known as the COMEX. COMEX, I think you may know, is the world's foremost futures and options market in precious and industrial metals. COMEX accounted in 1985 for better than 95 percent of the U.S. trading volume in gold, silver, copper, and aluminum futures. Throughout the world, the prices on COMEX are quoted and watched.

Mr. Chairman, with your permission, I will submit for the record an extended statement covering a number of issues that I think reauthorization ought to address, including the audit trail issue which you have heard extended testimony about this morning already.[1]

In my abbreviated remarks, however, I would like to present a final report on the challenge created a year ago when a COMEX member firm, known as Volume Investors Corp., sustained insolvency. Mr. Melamed referred to the Volume Investors matter in his testimony a few moments ago.

Second, I will outline why COMEX supported by the other major exchanges urges that the rogue form of futures trading known as leverage contracts, should be denied its present privileged status as the only futures activity that can be offered under monopolistic, noncompetitive and largely unpoliced conditions.

First, regarding Volume Investors.

Although the subcommittee may already be familiar with the events leading to Volume Investors Corp.'s insolvency, permit me a moment to recapitulate.

The gold market was quiet, even somnolent in 1984 and for about 75 days into 1985. Then, suddenly, a combination of economic crises, such as a run on some troubled thrift institutions and a rapidly declining dollar, caused gold prices to surge dramatically. In only 2 days, gold futures prices rose on the COMEX an unprecedented $44 an ounce, while gold options on the COMEX increased as much as 700 percent.

Volume Investors Corp., which I will shorten to Volume in this discussion, carried large positions in gold futures and gold options on COMEX for both public and floor trader customers.

On the eve of the gold surge, Volume appeared to have ample capital. Indeed its resources were more than twice the amount required of it by the Commodity Futures Trading Commission. Even so, the spectacular rise in gold prices in the short period of 2 days would prove too much for Volume, due to yet another rare event.

For three of its largest customers in gold options reneged on margin calls of $15 million, causing Volume to default on its own obligations to the Comex Clearing Association, the corporation that clears all transactions on the COMEX.

On the same day as this default, Comex Clearing Association ordered Volume to begin liouidating the troubled accounts. COMEX suspended the three customers and, as a result of a COMEX order, Volume was prohibited from taking on new business after that date.

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[1] See p. 227 for the prepared statement of Mr. Brody.

On the following day, as well, the CFTC succeeded in having an equity receiver appointed by the Federal District Court who took control of Volume's business affairs. Through this period and the days that followed, COMEX kept the CFTC fully apprised of the developments. In fact, CFTC personnel were on the scene, and we reported regularly to the CFTC's leadership in Washington.

An early—and controversial—decision that had to be made by the receiver was whether to transfer the accounts of other Volume customers to firms that were financially sound. After review, the receiver rejected that approach and, instead, ordered that all of Volume's customer accounts should be liquidated in the open market.

An examination of Volume's books and records after liquidation indicated that, when all of its remaining resources were combined, there were about $3.5 million less than were needed to pay all innocent, nondefaulting customers.

Immediately, COMEX undertook a search for ways to replace this shortfall. In the summer of 1985, a plan was finalized between the COMEX, Comex Clearing Association, the two principal owners of Volume Investors and the receiver that would have injected an additional $4.1 million. When a precondition to carrying out that plan did not occur on time, however, one of the Volume owners withdrew from the plan, cutting the fund by 50 percent. Within a matter of several days, a COMEX led effort resulted in revival of the plan which necessitated COMEX itself to provide a loan to the receiver in excess of $2.5 million.

I am pleased to report to you that, last week, the Federal District Court of the Southern District of New York approved this plan. COMEX's loan to the receiver was made, and Volume's customers are now being mailed checks that will reimburse them for their full equity balances.

The episode, despite its complexity and occasional frustrations, has ended with zero, I would repeat, zero losses in the accounts of the nondefaulting customers.

As I said in my opening remarks, I would like to proceed also to discuss the leverage contract issue.

COMEX has been an outspoken critic of the legalized monopoly enjoyed by a handful of companies that sell so-called leverage contracts to small public investors. That activity has spawned an unparalleled number of complaints to the CFTC by disenchanted leverage customers, and every one of the leverage firms has been sued by the CFTC for violations of the Commodity Exchange Act.

The time has come for Congress to put a halt to that activity, and the way to do so is by simply declaring that leverage contracts are futures contracts that must be traded, if at all, on an exchange where customers can enjoy competitive prices, the safety of a clearinghouse guarantee, and the protection of formal self-regulation.

To summarize, among the reasons why leverage should be stripped of its privileged status are these:

First, leverage contracts are actually futures contracts. COMEX, the Chicago Board of Trade and the Chicago Mercantile Exchange have conducted a comprehensive study of leverage contracts and have reached the same conclusion as the CFTC's own staff several years ago and reconfirmed by the CFTC in this reauthorization, namely, a contract for the future delivery of a commodity at a predetermined price and capable of offset, regardless of what you call it, is a futures contract under the act.

Second, off-exchange futures trading is unlawful and has been so since the earliest Federal legislation in 1922.

Third, futures trading must have a hedging or price discovery purpose and cannot be purely speculative. Leverage contracts have only one purpose, speculation.

Fourth, leverage contracts and fraudulent conduct have been inseparable partners. The absence of any self-regulatory machinery and the limited resources that the CFTC can devote to Federal oversight of that industry virtually guarantee sharp practices, unfair pricing, and one-sided contract terms.

Fifth, leverage contract dealers enjoy a monopoly power to set prices, to dictate contract terms, and to leave customers guessing whether their contracts will be bought back by the merchant if they become profitable. Our laws do not allow such an imbalance of power as between the dealer and his customers except in this field.

Sixth, and finally, the legitimate futures industry does not want the taint of this shadow enterprise, nor should the CFTC bear the brunt of criticism for the scandals that are a permanent fixture of the leverage business.

Accordingly, COMEX urgently requests that Congress compel these few leverage merchants to live by the same rules as the rest of us. The CFTC has proposed one solution, which is a welcome step in the right direction.

We think that the approach taken in H.R. 3434, which would directly, simply and finally declare leverage contracts to be unlawful futures as the better method of dealing with the problem.

Thank you for the opportunity to share our views. I would be pleased as well to answer any questions.

Senator HARKIN [presiding]. Thank you all very much.

I have some questions that the Chairman of the subcommittee wanted to ask. Before I do, I have one of my own.

Using the statement of the Chairman of the CFTC on this whole audit trail question, she said that the Commission was asked to approve a 30-minute banking rule for the Chicago Mercantile Exchange, send in a 10-slip system on which the time of the trade was recorded in 1-minute increments. And said despite Commission authorization of the banking rules, the Chicago Mercantile Exchange said they would continue its present system and continues to use this system of 1-minute timing recordation even though they experienced a 36-percent growth in volume in 1984 and a 47-percent growth in 1985.

The Chairman went on to say there were two other exchanges, the Kansas City Board of Trade and the Minneapolis Grain Exchange have 1-minute manual timing systems. In addition, the Philadelphia Board of Trade and the Amex Commodities Corp. had 1-minute trading timing systems.

Explain to me if this 1-minute system is so bad, is so detrimental, how are these other exchanges' systems better?

Mr. Gilmore.

Mr. GILMORE. The Philadelphia Board of Trade, to the best of my knowledge, trades no contracts week by week. They trade none.

Doing this off the top of my head, the Amex Commodity Exchange trade none. To cite those as footnotes in the report or statement are highly illusionary. Less than 100 contracts a week. Amex Commodity less than 100 contracts a week. These are my own personal estimates.

Mr. MELAMED. Senator Harkin.

Senator HARKIN. Yes.

Mr. MELAMED. What the chairman of the Board of Trade indicated is that in a system that trades very, very little or none at all, you could have 1 minute, you could have 30-second, you could have 1-second time recordation of sequencing if trading is slow enough.

If the CFTC were to institute the trade system that they suggest, we might slow down enough for that kind of trading.

Senator HARKIN. How about the Chicago Mercantile Exchange, how many do they do?

Mr. MELAMED. Well, it is something like 5 percent of the trade. We represent the two Chicago exchanges which trade 80 percent of the business. The COMEX is the largest of the remainder of the exchanges which combined represent 20 percent of the business. What is the percentage of the COMEX trade?

Mr. BRODY. Ours is about 14 or 15 percent.

Mr. MELAMED. That only leaves about 6 percent for the rest of the named exchanges, and with all due respect to them, and we love them dearly, they are not doing a large volume of business.

Senator HARKIN. I just wanted to clear that up.

Are there significant different distinctions between leverage contracts and futures contracts?

Second, what is the economic purpose of leverage contracts? Any purpose other than speculation.

Mr. BRODY. Senator Harkin, to repeat basically what I said in my oral testimony, and it is elaborated in my written testimony, I think in answer to your second question first, is there any purpose to leverage other than speculation, I think the answer to that is no. It is not required to demonstrate that there is any purpose other than speculation. I think in fact, as the CFTC has concluded, and I think the leverage merchants would agree, that they have no purpose other than to provide a speculative vehicle for certain investors.

I am sorry, the first part of your question was?

Senator HARKIN. Well, the distinction, is there a distinction?

Mr. BRODY. Between futures and leaverage contracts. In fact not. Like futures, leverage contracts are standardized contracts. The price is determined at the outset, most of them are liquidated by offset rather than delivery. There simply is no distinction except that one is traded on an exchange—and in the current system, one is traded off an exchange. Futures are traded under exchange self-regulation under a set of CFTC regulations, and leverage is not.

Senator HARKIN. There must be some difference there because futures contracts is a hedging instrument, used to hedge. If a leverage contract is pure speculation, then it is not used for that, is that right?

Mr. BRODY. To the best of my knowledge, leverage is not used for commercial hedging. Surely there is a difference in the setting of the price of a leverage contract versus a futures contract. The setting of a futures contract price is determined by an open, tested, proven auction market. The price of a leverage contract is determined by the principal to be—the sole principal to the transaction, which is the leverage merchant, who simply dictates what the price is.

Senator HARKIN. How many transactions per minute does a busy broker execute in an active market such as the Mercantile Exchange's S&P Stock Index or the Board of Trade's Treasury Bond? How many a minute?

Mr. MELAMED. It is hard to pinpoint the time because it depends upon whom that broker represents. If he represents a Goldman Sachs or Solomon Bros., it might very well be thousands within that minute. If he represents a much smaller house, it could be only several hundred.

Senator HARKIN. You are talking about contracts. I am talking about transactions.

Mr. MELAMED. Independent slips, independent transactions results?

Certainly in the terms—sometimes, of course, on a smaller house it could be three or four or five. It could be one.

Senator HARKIN. How about in your business, the Chicago Board of Trade, S&P stock, how many transactions, three, five?

Mr. MELAMED. I think it is very, very hard to tell you.

Mr. GILMORE. It is hard. It is time and motion, time and motion study. People operating in the trading pit could accomplish on a sustained basis 6 to 10 transactions a minute.

Mr. BRODSKY. Senator, let me try to help on that a little bit.

There are situations where an individual broker might have 1 transaction for 100 contracts, and yet have to trade with 10 or 15 people people in the pit. And then the amount of information that has to be recorded in order to complete that one transaction alone could take a couple of minutes in and of itself.

And, as Mr. Melamed said, there is great risk involved because when you are entering this information and comparing it, there is the financial risk of making errors that can complicate. And one of our concerns is that there already is so much information that has to be recorded that if this broker is doing 100 contracts, 5 with him, 10 with him, 20 with him, 30 here, et cetera, et cetera, by the time he has written all of this down, which he is already required to do, he already has another slip of paper for another order—and he has not yet finished the first transaction.

Now he is financially liable for the execution of the second transaction. Anything we do to burden that broker increases his financial liability and slows down the trading process increases the cost to the system. And that is on only one transaction.

Senator HARKIN. And as it is slowing down a little bit which is fit and proper. I mean just talking about the thing in a time allowance, again I do not understand. I can understand the small market is not doing as much. But I just say again I wonder how many do it in 1 minute. And you are saying it could be as high as 6 to 10 on a sustained——

Mr. BRODSKY. Transaction, multiple contract transaction.

Senator HARKIN. If they had to record the time every minute, what then is happening?

Mr. BRODSKY. We got it—cutting it down to 20 percent.

Mr. GILMORE. We have provided a system where the individual does not have to do this. Through the use of computerization, we can tell you when they executed that order. He does not have to. That is what we have offered to the Commission, a system that superimposes itself computerwise over the marketplace.

Mr. DONOVAN. Senator, one point. The time is not the only thing that would be reported when you got down to it. There are other bargain steps that have to be executed. When he executes an order, and if you walk by there and have 6 to 10 in that minute, we will tell you it is an onerous burden on that person to have to do it all at the time, same time, because if he fails to execute that order at that time, he is held liable for that.

Senator HARKIN. How many times does a selling broker make an offer before a sale?

Mr. MELAMED. That, too, depends on whether it is at the market and whether there is someone willing to buy at that moment. If so, he does not have to offer but that once. If there is nobody there, he will continue offering it for as long as it is viable and remains at the market. If no one buys it, he must continue to offer it. He is obligated to do so.

Senator HARKIN. How many times does a buying broker make a bid before purchase?

Mr. MELAMED. Same answer.

Senator HARKIN. I do not understand your answer.

Mr. MELAMED. Well, it would be very hard to answer that.

Senator HARKIN. What would the consequences for the customers be if the broker kept his head down? [Laughter.]

Mr. MELAMED. I think the idea behind that question probably is what Mr. Gilmore just indicated There are already a number of things that the broker must write on the transaction slip in order to report it properly, and in doing so, he must keep his eyes on the slip.

Another item to record is just one more difficulty that seems to him like a marathon, I am sure, and made more so because the next order is pressing at him and he has to look up and listen and execute or else be responsible.

So there is that difficulty involved for every broker.

Mr. GILMORE. There are six items involved, Senator, on an order now. Amount, price, time period, the period, my broker number, whether that may be indicated that I took the order, who I did it with you, and what permanent representative. There are six items I am going to put on there, and I am going to write the six down.

Senator HARKIN. You favor CFTC's proposal to eliminate judicial review in the U.S. district court?

Mr. MELAMED. None of the gentlemen at this side of the table would favor that. And I daresay most of the gentlemen on the other side of the table should not favor that.

Senator HARKIN. Do you have anything else you want to say before we move on?

Mr. MELAMED. Well, simply to say, Senator, that we hope that this panel will listen to our complaints and grievances because we are trying to protect a very important system for these United States, one that works. And we are proud to say one that our foreign competitors have yet to achieve the technology and knowledge of our industry.

If, as a result of regulation, we slow down the growth of our industry, what can happen to us has already happened to other industries in the United States. We just do not want to lose it to foreign competition. And we will, we certainly will. Somehow, we have always had in this country a willingness and desire to self-destruct in that process. We hope this will not happen to our industry.

Mr. GILMORE. The implementation of some of these rules that we mentioned today will make it very attractive to export our marketplaces because the price risk is not going to go out of these things. The need to hedge is not going to go out of these things. The need for price discovery is not going to get out

So if it becomes conducive to do those things in London or Tokyo or Sydney or Singapore, people are going to keep on doing these commercial transactions no matter whether they were designed, built, and fostered in Chicago over the last 140 years. They are going to go somewhere. The price risk in ownership in agricultural, nonagricultural things today is too great to have it not exist.

So we are dependent upon your existence to assure that the Commission does not make this a very easily exportable item. We have competitors out there on the international scene who would readily accept our business and the money to go with it and the bank deposits to go with it.

Mr. MELAMED. May I bring up one more item we have not covered but that is in the written testimony. That is the one that deals with the eventual definition of what must be regulated and what must be traded on an exchange. It is called the off-exchange issue, and a bit tangentially, is the leverage issue. But this goes beyond that. And the CFTC is entertaining a discussion about the type of contracts that can be traded off an exchange.

Our view is that if it looks like a future and trades like a future, and is a future, it ought to be regulated by the CFTC on the exchanges. That is a very broad stroke general rule, but it is the one we are trying to achieve with the CFTC.

Senator HARKIN. Mr. Brody, do you have anything?

Mr. BRODY. Nothing to add. Thank you.

Senator HARKIN. Well, thank you all very much for coming and presenting your testimony.

The next panel will be Mr. Carabini, president of Monex International, Ltd., and Harvey Kochen, vice president of International Precious Metals Corp.

Gentlemen, welcome to the Agriculture Committee. I have copies of your statements which will be inserted in the total record.

I recognize Mr. Carabini first. State your name and who you represent, and proceed with your testimony, please.

STATEMENT OF LOUIS E. CARABINI, PRESIDENT, MONEX INTERNATIONAL, LTD., NEWPORT BEACH, CA

Mr. CARABINI. Good morning, Mr. Chairman.

My name is Louis Carabini, and I am founder and president of Monex International, a leverage transaction merchant registered by the CFTC and located in Newport Beach, CA.

I have testified on legislation to authorize the CFTC on two previous occasions, and I appreciate the opportunity to appear before your committee again today. I am here to oppose the legislative proposal of the CFTC and the recommendations of the futures exchanges who have testified to ban leverage contracts.

Monex was founded in 1967, and today employs over 200 people Monex currently has about 14,000 active customers, with whom it conducted over one-half billion dollars in leverage transactions during 1985 alone. Since 1967, during our nearly 20-year history, Monex has engaged in over $8 billion in leverage transactions with over 75,000 customers. During each of the last 4 years, we have averaged over 40,000 separate leverage transactions. Approximately 85 percent of Monex transactions involve leverage transactions. The company also offers dealer options.

In 1974, Congress created the CFTC and, among other things, directed it to regulate leverage contracts. But the CFTC adopted only a general antifraud rule. Then, in 1978, the CFTC, just as it is today, asked Congress to repeal its jurisdiction over leverage transactions. Congress rejected the Commission's request and reordered it to promulgate regulations.

In 1979, the CFTC proposed for the first time to ban all leverage transactions by declaring them to be futures contracts. And it imposed a moratorium on the entry of new firms into the leverage business. In 1982, still seeking regulatory protection for public customers, Congress told the CFTC that leverage contracts are not futures contracts, and again demanded the promulgation of regulations. And finally, in 1984, the CFTC adopted comprehensive regulations to govern the leverage industry.

Two major companies were in this business prior to the creation of the CFTC. Today, 12 years later, the same two companies—Monex and International Precious Metals Corp.—are the only two companies licensed under the agency's new regulations. Together we sought regulation for over 10 years. When we finally got it, we complied at a great cost, I might add. Since 1984, Monex has spent over $1.4 million to meet its new regulatory obligations.

Twenty-two months later, the CFTC wants you to ban the very product and business practices we just changed in order to conform to their new requirements. Repeal of section 19 will outlaw leverage contracts—transactions molded by the CFTC's own definition—as illegal futures contracts.

What is the Commission's rationale for this proposal?

Primarily, they argue that leverage contracts are really futures contracts and, therefore, must be traded on designated exchanges. But leverage contracts are fundamentally and legally distinct from futures contracts. Mr. Chairman, I have prepared a detailed discussion of these differences which I would like to submit with my testimony for the record.[1]

If, on the other hand, insufficient regulatory resources are the problem, an easy solution exists. The National Futures Association could assume the job of primary regulator. Monex is already a member of NFA. This is also true of most, if not all, of those firms who would ever enter the leverage business. To the extent regulatory responsibility for leverage might increase NFA's operating costs, it could recover those costs directly through leverage member fees.

The three largest futures exchanges, which trade some of the same commodities Monex offers pursuant to leverage contracts, have also mounted a campaign to ban our business. Where were these exchanges in 1974 and in 1978 and in 1982? They sat right here, and never once expressed concern over leverage contracts being futures contracts. Moreover, for 10 years, while the CFTC refused to adopt comprehensive leverage customer protection regulations, they sat here in silence on that issue as well. Now, that tough leverage regulations are in place, however, these exchanges urge that retail commodity customers must, for their own good, have investment opportunities restricted by law to exchange traded products.

Times have changed, Mr. Chairman, and this sudden interest by these exchanges just does not ring true. The financial press has reported that over the last several years public customers have virtually disappeared from the futures markets. Troubled exchange leaders now ask you to believe that leverage contracts are somehow at least partly responsible, and that an expanded leverage industry would increase the problems and destroy market liquidity.

But leverage contracts are not the culprit. Leverage dealers do not even compete with the exchanges. If our business were banned, very few of our customers would speculate in the futures markets. Not only do we not compete with futures markets, but Monex is a major institutional hedger. By covering obligations to its customers in the futures markets, Monex adds substantially to the liquidity of those markets. The value of our futures positions last Friday, February 14, for example, was $138 million, a typical position.

Healthy competition between substantial, well-regulated dealers would result in even more liquidity on the exchanges. The benefits of expanding this dealer competition would also include a much greater public awareness of lawful alternatives to the fraudulent boiler room schemes which flourish in the absence of legitimate competition.

If Congress were now to repeal section 19, the prospect of legitimate alternatives for these customers would disappear. By abolishing the stringent Federal regulations applicable to leverage transactions today, Congress would actually increase the problems of off-exchange fraud. Some States would continue to protect their citizens very well, others adequately, and most not at all. In short, you would ban the business of the only two companies in the country who have satisfied strict Federal regulatory requirements, and you would otherwise do nothing toward preventing the spread of off-exchange fraud.

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[1] See p. 237.

Mr. Chairman, leverage contracts exist today to meet the investment demands of thousands of customers. These customers are well protected by an extremely restrictive program of Federal regulation. If the CFTC cannot, the NFA is certainly capable of handling day-to-day regulation of today's two-company leverage industry. It will be equally capable of regulating a leverage industry which could be cautiously expanded in the months or years ahead.

No new evidence exists to justify putting our companies out of business after all these years. All that has changed since 1982, when Congress last addressed this subject, is that strong regulations are finally in place. Therefore, I urge you to reject the Commission's latest attempt to shed its regulatory responsibilities. Life might be a little bit easier at the CFTC, but that would be at the direct expense of thousands of members of the investing public, and of the livelihoods of leverage merchants and their hundreds of employees.

The blandishments of the exchanges to destroy the leverage business should likewise be ignored. They are based upon anticompetitive self-interest. An effort to codify a monopoly over retail commodity customer transactions is reprehensible in its own right. When that effort is undertaken in the name of customer protection, it borders on customer abuse itself.

Section 19 of the Commodity Exchange Act should be left unchanged, and Congress should direct the CFTC to lift its leverage moratorium.

Thank you, Mr. Chairman, for the opportunity to appear before you again today. I will be pleased to answer any questions.

Senator HARKIN. Thank you very much, Mr. Carabini.

Mr. Kochen, I will call on you to make your oral statement. Please go ahead.

STATEMENT OF HARVEY KOCHEN, VICE PRESIDENT, INTERNATIONAL PRECIOUS METALS CORP., FORT LAUDERDALE, FL

Mr. KOCHEN. Mr. Chairman, members of the committee, my name is Harvey Kochen, and I am a vice president of International Precious Metals Corp.

Thank you for this opportunity to address you today. I have included with this statement an extended statement which I would request be included in the record.[1]

IPMC is a leverage transaction merchant registered under the Commodity Exchange Act. IPMC has approximately 200 employees in Fort Lauderdale, Boca Raton, and Newport Beach. We have been in the business of selling commodities on leverage since 1973. At the present time, we have approximately 2,400 leverage customers.

I am here today because the Commodity Futures Trading Commission has proposed that Congress eliminate the regulation of leverage transactions from the act. It is the Commission's view that leverage contracts and futures are legally and economically indistinguishable and therefore do not justify separate statutory treatment.

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[1] See p. 283 for the prepared statement of Mr. Kochen.

The Commission has suggested that we might change our business in order to exist under State regulation.

We oppose the Commission's recommendations.

I would like to make three points this afternoon:

One, leverage contracts are not the same as futures contracts.

Two, the new leverage regulations are effective; and

Three, responsibility for regulating the leverage business is properly placed with the CFTC.

First, leverage contracts are not the same as futures contracts. There are clear legal and economic distinctions between the two.

A leverage contract is an agreement to purchase a commodity from a dealer at a fixed price for later delivery.

A futures contract is an agreement to purchase a contract. Both the buyer and the seller margin their agreement with a performance deposit. It is designed primarily as a price hedging vehicle, not one for delivery.

Because leverage contracts and futures contracts are similar in many respects, they should have the same regulatory oversight. But because of their differences, they each require special statutory treatment to protect the public.

The fact is that a leverage contract is a distinctive retail product that is not available on the futures exchanges. Since the adoption of the CFTC Act of 1974, Congress has recognized that leverage contracts are different instruments from futures contracts.

Almost 10 years ago, in July 1976, a CFTC advisory committee on market instruments conducted——

Senator **Wilson** [presiding]. Excuse me. Let me interrupt you. I had hoped that some of those members voting would have returned so that we would not have to interrupt you. But I am afraid that Senator Harkin and I must go vote, and we invite you to remain. I will return. I hope by the time I return, I will find someone else in the chair, but I will return in any case.

But if you will excuse us, we will be back as quickly as possible.

The committee will be in recess briefly.

[Short recess].

The **Chairman**. I believe you were in the midst of your testimony.

Mr. **Kochen**. Yes, sir.

The **Chairman**. You may proceed, and I apologize, but that is the way this place works.

Mr. **Kochen**. Almost 10 years ago, in July 1976, a CFTC advisory committee on market instruments conducted a study of leverage transactions. After almost 1 year and several public hearings, the committee found that leverage transactions were sufficiently different from exchange traded futures transactions to justify the separate regulation of leverage contracts. The advisory committee proposed specific and comprehensive recommendations. Those proposals formed the basis for the present leverage regulations. The second point is that the leverage regulations are effective.

The public is now protected in these regulated off-exchange transactions by rules that require:

A minimum adjusted net capital requirement of $2.5 million.

Customer funds be segregated from the leverage merchants' funds.

The leverage transaction merchant covers its obligations to its customers.

Commodity customer safeguards that are unprecedented, such as the limited right of rescission for a first-time customer, the limited right of reestablishment of a liquidated undermargined position without charges or fees, and mandatory breakeven disclosure to customers.

These rules require the registration of the merchant, its principals, sales personnel, products, and the customers disclosure documents.

These rules are very effective. Customers are given proper disclosure, and they are protected from manipulation and fraud. The rules ensure the financial solvency of these transactions.

The leverage regulations have been in force since mid-1984. We have not had a single customer reparations complaint or civil litigation suit brought against us by a leverage customer whose account was established under the new leverage rules.

The third point is that responsibility for regulating the leverage business is properly placed with the CFTC.

Leverage contracts are a variation of forward contracts, and are similar to futures contracts. They are properly regulated as commodity interests under the act and subject to oversight by the CFTC. Congress has made this clear since 1974.

Federal jurisdiction has provided uniform and consistent regulation of these transactions.

If Congress withdraw leverage regulation from the Commodity Exchange Act, the regulated leverage transaction will become illegal. Our regulated leverage business will be destroyed because there are no existing State regulations within which to effectively carry on this business.

However, our customers and our market will still exist. Similar type instruments not subject to Federal regulation will be made available to meet this demand. The maze of various State regulations do not provide the protection now afforded by the existing regulations. The public will be better served by maintaining the existing Federal regulatory framework.

The burden upon the CFTC of direct regulation can be alleviated by transferring the direct regulation of the leverage industry from the Commission to a designated self-regulatory organization.

The National Futures Association is the appropriate self-regulatory organization for that responsibility. They already supervise and audit futures commission merchants and other registrants. The cost of regulating the leverage industry would then be borne by the leverage industry itself from member fees and from transaction fees.

In conclusion, IPMC opposes the CFTC proposal that Congress withdraw leverage regulation. The facts are clear. Leverage transactions are different from futures contracts. Consumers want the alternative of leverage transactions. The new leverage regulations are effective, and the responsibility for regulating the leverage business is properly placed with the CFTC.

We request a settled regulatory atmosphere in which to conduct our business and serve the needs of our customers.

We urge you to maintain the existing regulatory framework for leverage transactions. It is unfair to put legitimate companies out of a legitimate business.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Kochen.

Senator Wilson, do you have a question?

Senator WILSON. Thank you, Mr. Chairman. Yes, I do.

First I thank the witnesses for attending.

The CFTC has referred to previous testimony of Monex, indicating that 50 percent of your customers take delivery of precious metals. Therefore, only half of your business presumably involves leverage transactions and would be affected by repealing section 19.

Is that an accurate assessment?

Mr. CARABINI. Not totally accurate. It is true that approximately 50 percent of our customers take delivery of something. What is correct is that about 10 percent of our leverage transactions result in delivery. There are two different figures. So, indeed, if we were banned from the leverage business, it would destroy 90 percent of our business.

Senator WILSON. The CFTC also reports that an inordinately high percentage of customer complaints involves leverage transactions.

For example, prior to the 1984 regulations, four companies authorized to offer leverage contracts accounted for 11 percent of the complaints received by the Commission. During the past 22 months, with the new regulations in place, this percentage has dropped to 5.5 percent.

Would both of you, Mr. Carabini and Mr. Kochen, please comment upon your own companies' complaint history before and after the promulgation of the CFTC regulations?

Mr. CARABINI. Prior to the promulgation of the regulations, we did have an inordinate amount of reparations cases filed. Most of those cases were filed as a result of transactions occurring from the very rapid rise and fall of silver during the early part of 1980.

I believe, although, if regulations had been in place, we would only have seen a fraction of those reparation cases.

Currently there are only, as I recall, 11 reparation cases open. But let me address the time period during which the regulations have been in place.

Taking into consideration the transactions that occurred during that 22-month period, which involved, by the way, 70,000 transactions involving about 25,000 customers, we had four reparation cases filed, for a total amount of $16,500 in claim value. Two of those have been settled so there are only two cases remaining of those periods during the regulations.

Senator WILSON. Mr. Kochen.

Mr. KOCHEN. Our experience has been that since the regulations we have had an insignificant number of customer complaints. Another good indication of customer complaint measure is rescissions. The customers made a purchase and then chose to rescind.

Again our experience has been that the number is insignificant.

Senator WILSON. Can you quantify that?

Mr. KOCHEN. Yes. We had 12 over the past year.

Senator WILSON. What is that in percentage of your total volume?

Mr. KOCHEN. I do not know. I really do not know. But in terms of thousands of transactions, it is an insignificant amount.

In terms of customer complaints, if I had three, I would be surprised. I keep track of that.

Senator WILSON. I wonder if you could quantify insignificant?

Mr. KOCHEN. In terms of customer complaints, I do not think I can think of three customer complaints. And I would be exaggerating to say—we have no customer complaints any more in this area.

Senator WILSON. One of the concerns about leverage contracts is that they are not as liquid as futures contracts. In other words, the holder of a futures contract is probably better able to sell it because the exchanges with which he would trade in futures offer numerous potential purchasers, as well as the security of the clearinghouse guarantee; whereas the exchange traders would argue that a leverage contract can only be sold to the company that offered it.

Some consumer complaints involve instances where a customer wanted to sell back his contract, gold or silver, after its value had increased. But the leverage contract merchant, for whatever reason, refused to purchase the instrument.

Would you please comment about the liquidity of both leverage and futures contracts, and would you specifically indicate any instances in which your companies have refused to purchase back the leverage contract?

Mr. CARABINI. If I may go back through our history of about 20 years, during that 20-year period we were unable to make a market only, as I recall, for brief periods or 4 or 5 given days.

In 1974, we discontinued making a market, and by making a market I mean an offer to buy or sell. That interruption was for 15 minutes. The next interruption came, I believe, in the latter part of 1978, and that was only for a few minutes. The longest duration during which we were not able to make a market was in January 1980. There were 2 days during which about 2 to 3 hours, during which we were unable to make a market because of the volatility of that market.

I must comment, by comparison to the futures market, during January particularly of 1980, those markets were closed because of limit changes in prices. And, therefore, there was no trading, no one could get in or out of those markets during many of those days. I am not aware of any leverage customer on a rising market who was not able to sell his commodity. I do though must say during those interruptions, when the market dropped, it was much more difficult to make a market for the complete day. But it was only an interruption during our 11-hour trading day.

Mr. KOCHEN. I concur exactly.

Last year, I think it was March 1985, during hearings in front of the House, on that very day, the market in gold went the—the gold stopped trading because when it moves, our company continued trading, and the customers were taking their profits.

Senator WILSON. Another concern which representatives of some of the commodity exchanges have expressed to my office involve consumer protection. And obviously this is a major concern which I think we all share.

Specifically, as an example, I have been told that, unlike futures contracts, which are bought by investors, leverage contracts are sold primarily through rather slick brochures, and some would claim through rather misleading sales techniques to less than sophisticated investors.

I would ask you to explain what protections are provided to your customers both by your own business practices and through the CFTC regulatory requirements?

Mr. KOCHEN. Well, first of all, attempts to customers kind of depend upon a set of details. The disclosure document on the leverage account is very, very extensive. There is nothing comparable in the futures market. And we have to give notice—off the top, I think it is a 30-day notice, to the Commission to make any changes whatsoever, and they have an opportunity to come in and negotiate or tell us no, whatever. We work something out.

In terms of brochures, we are subject to all of the rules of proper disclosure under the act, and we have recordkeeping requirements where our marketing material is maintained. It is audited by the Commission. We would hope some day by a self-regulatory organization.

And speaking for our own company, we have our own internal procedures for making sure that the marketing material is properly approved, the same way that the futures exchanges are.

In terms of the glossy brochures, as far as I know, the existing leverage merchants have, I think, attractive marketing information, but nothing that I would call slick.

Senator WILSON. Mr. Carabini?

Mr. CARABINI. If I may briefly comment. I have not compared our disclosure documents and offering statements with every FCM, but I have not seen an FCM brochure or disclosure as extensive as ours.

On the comment about our type of customers, it was indicated earlier today by one of the exchanges that our customers are naive.

Let me give you an idea about the type of customer that we attract, and this was a survey that was conducted by Polaris Research Associates of New York about 3 or 4 years ago. And to give you an idea, 63 percent of our customers have college degrees. I must say that many of our customers will include lawyers, doctors and accountants; and over the years, I must also add, of these naive individuals, many of them included Members of this Congress.

So, I am very insulted when I hear statements made by our competitor, the exchanges, that our customers are naive and that we are forcing them into these types of investments.

Certainly we have salesmen who are paid commissions to make sales. It is true that they make our product attractive to the customer. But those customers come to us not by cold calls but through advertising, primarily in the Wall Street Journal, and 30 percent of our customers come to us as a result of referrals. Those customers are satisfied with our services.

Senator WILSON. Do you gentlemen have any data comparing investor return on futures and leverage contracts?

Mr. CARABINI. Yes. In my testimony, I have asked to submit to this committee a very extensive study on the comparison of leverage contracts and futures contracts, both in their fundamental aspects as well as the cost comparison of each. I will provide whatever number of copies you need of that particular study, but it does include a comparison of the costs.

Did you want me to comment on those cost comparisons?

Senator WILSON. You may now. But actually I was asking for a comparison in written form for the record.

Mr. CARABINI. Yes, I would be happy to supply it.

Mr. KOCHEN. Senator, for the record, I have in my written extended statement a copy of a report that our company commissioned back, I think, in 1977-78, done by a Prof. Roger Grey, Stanford University. In that—it is submitted as part of the record now—he compared the retail customers in futures with leverage. You will see that it is very comparable.

Senator WILSON. Let me ask just two more questions, Mr. Chairman. I thank you for your courtesy. I do not want to extend this unduly.

But my impression is that if the moratoria were lifted and additional companies not now involved in offering leverage contracts would be permitted to do so, that you would welcome the competition.

Mr. CARABINI. Yes, I would. On behalf of Monex, we have stated this in testimony before this committee and the House committee on a number of occasions.

We believe open competition is best for us and the customer.

Senator WILSON. Let me just ask about the kind of consumer protections that are given to those in the stock market from NASD. In your statement, Mr. Kochen, I gather that you are in agreement with Mr. Carabini that the delegation of some of the responsibilities of CFTC to an industry-funded group like the NFA would provide the same kind of protections to leverage contract purchases?

Mr. KOCHEN. That is true. The basis of regulation of an off-exchange vehicle has been embodied in the current CFTC rules of disclosure, financial requirements, regulation and oversight. As long as you have these, you will have the proper protection that we need in order to offer these instruments to the public.

Senator WILSON. Mr. Chairman, I wonder if there has been any comparison of the volume of complaints received from customers in the futures market with regard to on-exchange transactions as compared with off-exchange leverage transactions?

The CHAIRMAN. Let me inquire of staff.

Has there been?

Mr. WEAR. Not to my knowledge, Mr. Chairman.

Senator WILSON. Well, it would seem that it would not be impossible to acquire this information. I do not want to be comparing apples with bananas, but I think it can be done, and I think it might be instructive. So, I would make that request, Mr. Chairman, that the staff do so.

Mr. KOCHEN. May I point out one interesting point. The point is an interesting one because the leverage industry has been stuck with—whenever there is a complaint, stuck the CFTC with a very public reparations process, the people that are—the FCM's and the member exchanges have the benefit of having their disputes resolved in a very nonpublic arbitration process. So, our complaints are public and highly visible, high profile, where complaints handled through the exchanges are handled in a more informal arbitrary—not arbitrary—arbitration process which is not public.

So, like you say, it is difficult to compare.

Senator WILSON. Mr. Chairman, I will just conclude by saying I think from the standpoint of the consumer, the investor in the marketplace, we ought to be concerned not about guaranteeing returns or profits to investors. But I think that a comparison of the complaints might be instructive, and a comparison of the returns might also be instructive. If there are, in fact, profiles of the customers who invest in futures versus leverage contracts, that too may be instructive.

I think that takes care of my questions. Thank you, sir.

The CHAIRMAN. Thank you, Senator, and thank you, gentlemen. Am I correct that this terminates today's agenda?

Mr. WEAR. Yes, Mr. Chairman. The committee has scheduled a meeting tomorrow morning at 10 o'clock to hear further testimony.

The CHAIRMAN. Very well.

Let me say again that I regret the necessity of my having to arrive so late for this initial hearing on the subject of the reauthorization of the Commodity Futures Trading Commission and, without objection, the balance of my statement will be printed in the record.[1]

Thank you, gentlemen, and thank all of the good people who preceded you here this morning. If there is no further business to come before the committee, we stand in recess.

[Whereupon, at 12:45 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, February 20, 1986, in room 328-A, Russell Senate Office Building.]

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[1] See p. 163 for the prepared statement of Senator Helms.

REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

THURSDAY, FEBRUARY 20, 1986

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The committee met, pursuant to notice, at 10:09 a.m., in room 328-A, Russell Senate Office Building, Hon. Richard Lugar presiding.

Present: Senators Helms, Lugar, Zorinsky, Leahy, and Melcher.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Senator LUGAR. This hearing of the Senate Committee on Agriculture, Nutrition, and Forestry is called to order. I am pleased to continue our hearings on reauthorization issues of the Commodity Futures Trading Commission.

We are delighted to have a distinguished panel before us and the distinguished chairman of the committee here to help us in both listening to the witnesses and asking questions of them.

Gentlemen, following the rule that we commenced yesterday, would you try to hold your testimony to about a 7-minute period so that we will have ample time to get the issues before you. Your full statements, of course, will be made a part of the record. Then we will proceed to questions.

The Chair would like to introduce the first panel: John Damgard, president of the Futures Industry Association, Washington, DC; James A. Layton, president of Clayton Brokerage Co. of St. Louis, St. Louis, MO; and Gary L. Seevers, vice president, futures department, Goldman, Sachs & Co. of New York.

Gentlemen, would you proceed.

STATEMENT OF JOHN DAMGARD, PRESIDENT, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, DC, ACCOMPANIED BY ARTHUR MARCUS, CHAIRMAN, AND SENIOR VICE PRESIDENT OF PAINE, WEBBER, INC.

Mr. DAMGARD. Mr. Chairman, members of the committee, I am John Damgard, president of the Futures Industry Association.[1] Accompanying me today is Arthur Marcus, chairman of the FIA and senior vice president of Paine, Webber, Inc.

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[1] See p. 308 for the prepared statement of Mr. Damgard.

The FIA is the national trade association for the commodities futures and options industry. Our regular membership is composed of over 100 brokerage houses, called Futures Commission Merchants, or FCM's.

FIA member FCM's are estimated to transact over 80 percent of the public customer trade on U.S. commodity exchanges. Our association also counts among its membership, all U.S. exchanges, many law and accounting firms, foreign exchanges, foreign brokerage houses, and banks.

While we value all of our members and strive to represent the industry as a whole, our roots are in the brokerage community and we remain primarily an FCM association.

FCM's are the industry's link to the trading public. Our members serve public customers, be they farmers, mutual funds, pension plans, savings and loans or local and foreign governments. FCM's must assure the public that these markets are fair and answer to the public on those occasions when the perception is to the contrary.

Thus, we have a vital interest in thoughtful regulation of the marketplace and increased efficiency in the transaction of business. Our public demands this and we can accept nothing less.

The FIA recommends reauthorization of the Commodity Futures Trading Commission for a 6-year period. While the FIA is generally pleased with the evolution of the regulation under the CFTC, there are a number of programs, some of which are regulatory and not legislative in nature, about which I would like to briefly comment.

OPTIONS

A great deal of attention has been focused in the past year on the default of Volume Investors' Corp. and its impact on the Commission's options program. As a result of the Volume default, the Commission identified what they believe to be various weaknesses in the current regulatory framework.

These perceived weaknesses and potential remedies are the subject of ongoing debate within the industry and between regulator and regulated. It is our hope that the end result will be a rational regulatory framework that does not drive the industry to its knees.

Nevertheless, the options program should not suffer from a single controversial incident, nor should the current restrictions on expansion of the program be maintained.

INSURANCE

The controversial Volume Investors' problem gave rise to renewed cries by some that the commodity futures and options industry should provide insurance or customer account protection in some form. In response, the Commission ordered the NFA to undertake a study of customer account insurance and we anxiously await the results of this study.

The importance of customer confidence in the financial integrity of the futures markets is tremendous and, I would add, well deserved. Between 1971 and 1984 customer losses amounted to $9.7 million in the commodities industry. During the same 13-year period, total securities customers' claims amounted to about $690 million, for which SIPC paid out $153 million. $10 million in security customer losses were not covered by SIPC. Thus, even with the SIPC program, customer losses in the securities area exceeded those in commodities.

Insurance in the securities industry and other segments of the financial marketplace, including banking, has presumably played a significant role in the protection of customer funds; but at what cost?

Do market users exercise less than sound business judgment in selecting a firm when there is an insurance firm in place? Are the firms themselves, less cautious in their hiring of employees, screening of customers, or handling of accounts and cash? Do the self-regulatory organizations enact fewer or less stringent rules designed as preventative measures? If the answer to any of these questions is yes, then the trade-off for having insurance cannot be taken lightly. While the present system is certainly not perfect, it has worked remarkably well for many years.

The best insurance is a strong clearing organization, properly capitalized firms, and a sound self-regulatory framework with competent CFTC oversight that is effectively and consistently enforced.

HEDGING

The CFTC's hedging definition, promulgated prior to the development of the financial futures market, is not appropriate for today's markets. The situation is long overdue for reexamination and promulgation of a more realistic hedge definition for financial futures.

OFF-EXCHANGE TRANSACTIONS

The FIA urges the Congress and the Commission to be extremely cautious in considering any legislation in the very broad area of off-exchange transactions. There is clearly a legitimate role for the CFTC in enforcement of section 4 of the act, which requires that all futures contracts be traded on a designated exchange. It does not follow, however, that all off-exchange transactions violate section 4. There are a myriad of vitally important nonexchange transactions that cannot legitimately be characterized as off-exchange futures, and should not be.

We fear the easy way out for regulators would be to characterize these transactions in such a way--as off-exchange futures—to destroy these markets which legitimately provide hedging and investment opportunities for large and knowledgeable participants.

The interbank currency market, interest rate swaps, forward-rate loans or deposits, cross-currency rate swaps, Eurocurrency loans with marketable caps, and many more financial transactions and arrangements provide corporate treasurers and financial officers with the flexibility to operate in the economically most efficient manner.

In some instances, these varied financing arrangements—and perhaps some not as yet even developed—will best serve commerce. It would be a tragic mistake to interfere in such sophisticated markets without first fully exploring the ramifications of such intervention.

AUDIT TRAIL

The CFTC published a final rule on January 14 requiring that each side of all trades have, on the trade register, an execution time identified to the nearest minute. This final rule raises many questions about whether liquidity of the market and the speed of trade execution would be adversely affected.

In the past week, what appears to be a viable system of timing has been jointly proposed to the CFTC by the Chicago Board of Trade and the Chicago Mercantile Exchange.

The FIA strongly encourages the CFTC and the exchanges to fully develop this proposal to determine whether it can provide a meaningful, accurate audit trail. The audit trail issue presents highly technical problems whose resolution lie properly in the regulatory arena.

We applaud the motives of the CFTC and look forward to continuing progress where the CFTC, FCM's and the exchanges work together to foster greater public confidence in these markets.

NFA. The FIA applauds the progress of the NFA over the past 3 years. It has proven itself to be a self-regulator responsive to its oversight authority.

We join with the NFA and the exchanges in opposing the CFTC's request for additional rulemaking authority over the NFA.

Mr. Chairman, the FIA appreciates the opportunity to present its views to the committee. The FIA offers the committee the assistance of the staff and its membership in this most important undertaking.

We would appreciate the opportunity to submit a written statement in addition to my spoken statement. Mr. Marcus and I are pleased to answer any questions.

Senator LUGAR. Thank you very much, Mr. Damgard.

Mr. Layton.

STATEMENT OF JAMES A. LAYTON, PRESIDENT, CLAYTON BROKERAGE CO. OF ST. LOUIS, ST. LOUIS, MO

Mr. LAYTON. Mr. Chairman, and members of the committee, my name is James A. Layton. I am president of Clayton Brokerage Co. of St. Louis, a full-service futures commission merchant located in St. Louis, MO.[1]

We have 27 branch offices, a substantial home office with research and clearing capabilities, and over 150 introducing broker agents. We have been in the commodity futures business since the early 1950's.

We are pleased to have this opportunity to offer the views of our firm in connection with your consideration of legislation to reauthorize the Commodity Futures Trading Commission.

I would first like to address my remarks to agricultural futures options and the design of the industry to have the pilot program, which is currently in effect, terminated and that replaced with a permanent, and that program to be able to be expanded into the other areas of agricultural products.

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[1] See p. 312 for the prepared statement of Mr. Layton.

Now, contrary to some beliefs, agricultural options have been extremely successful on their kick-off. Despite the generally depressed agricultural markets, they have exceeded the initial performance of nonagricultural options at a similar stage.

Clayton Brokerage clients have found agricultural options to be a useful tool in the marketing of farm and ranch production, and the theoretical advantage of commodity options provide producers in stabilizing and enhancing their incomes; and these are well documented and have many, many articles and publications on options trading which will verify this.

We would like to provide the use of real-life examples of how our farmer/rancher customers and clients have benefited from the availability of commodity options. We have found all options to be useful to individual customers.

Our experience has been the cattle options have been the most popular with agricultural hedgers. Cattle options have also found a ready acceptance in the cattle industry at large.

On February 18, a year and a half after the introduction, open interest in cattle options totaled 30,000 contracts. It took more than 4 years for cattle futures to attain the same level of participation.

Recently, the number of cattle options traded averaged 23 percent of the futures volume. Now, that is somewhat below, but is rapidly approaching the 41 percent in Treasury bonds, for example: by far the largest options market in the world.

Over the past year, cattle options volume, however, has grown 680 percent against 350 percent growth in T bonds. By many standards, the cattle option market has been a good success.

Since the commencement of cattle options trading on October 30, 1984, cash cattle prices in Omaha have varied from $53.35 to $66.50 per hundred. Feeding margins—the value of live cattle minus feed and feeder steer costs—averaged $5 a hundred.

Just one month's variation in price would nearly wipe out the feeders' profit margin. The Corn Belt feeders typically hold cattle for a 6- to an 8-month period.

Our clients have found that using a put option, for example, is a convenient means of insuring against price decline potential and still benefit if the prices should be moved sharply higher. Futures markets provide a means of hedging that does not allow the feeders to participate when prices move up.

Farmer feeders are optimistic by nature, but their bankers don't always have that enthusiasm; and many banks, now, are requiring that farmer feeders hedge their operation by providing additional security to their production loans.

Options provide a means for farmers to provide proof that loans are secure and still indulge their optimism.

Some producers also enjoy the lack of worry over margin calls when futures prices are moving against the futures positions, for an example of that on the margin call. Small producers, especially, can lack the facilities of financing and maintaining margin money in fast-moving markets.

With options, these producers can make deposits to cover their premium costs and do not have to be concerned with additional margin money should the price decline.

I have provided an exhibit A which gives a little background on a Texas cattle feeding operation. This rancher had 225 cattle on feed in early December with cash cattle trading at $66 a hundred. He purchased six February cattle put options at that time; the feeders liquidated these options at expiration in late January and entered into a short future position.

In early February, he sold his cattle for $57 a hundredweight and liquidated the futures position. The farmer calculated his cost of production at $61 a hundredweight, which would have resulted in $4 a hundredweight, or nearly a $10,000, loss on the 225 head of cattle. However, with the put option transaction, he netted $5.50 per hundredweight, or a little more than $13,400.

In summary, the farmer ended up netting $3,400 from his feeding operation where, without the use of the put, he would have suffered a $10,000 loss.

This is just one small example of how farmers have been benefiting by options trading. We have included some other examples for your examination, and we would appreciate anything that would be of help to you with this.

We really sincerely believe that this pilot program should be terminated and made permanent, and that agricultural options should be expanded into other agricultural products.

Next, I would like to just comment briefly on the proposed changes to the CFTC capital rule to reshape the futures business by changing the way the firms do business in light of the recent bankruptcy of Volume Investors.

We recognize the need for firms to have adequate safeguards. However, in the interests of competitive society, we feel it is imperative that rules not be made so restrictive that they force many firms out of business and leave the industry in the hands of a few very large corporations.

Last, regarding the 1-minute trade execution reporting rule, we have never had a customer complaint that related to the audit trail problem involved in the new proposed CFTC regulation. While we do not believe there is evidence of frequent widespread market abuse, like others in the industry, we recognize that there must be a system to prevent such abuses.

However, this system must be practical. It should not be so sophisticated, cumbersome and complicated that it interferes with the working of the greatest free market in the world.

We appreciate the opportunity of appearing before you. Thank you.

Senator LUGAR. Thank you very much, Mr. Layton.

Mr. Seevers.

STATEMENT OF GARY L. SEEVERS, VICE PRESIDENT, FUTURES DEPARTMENT, GOLDMAN, SACHS & CO.

Mr. SEEVERS. Thank you, Mr. Chairman; Chairman Helms; and committee members. It is a pleasure for me to submit a statement on a single regulatory issue, which is the Commission's definition of hedging. Mr. Damgard referred to that in his testimony and I believe Mr. Malamed did, also, yesterday.

My name is Gary Seevers. As you indicated, I am employed by Goldman, Sachs. We are an investment bank and a registered FCM. At Goldman, Sachs, I am responsible for our client business in futures and options, which is primarily in interest rate futures and stock index futures; but we are also active in energy futures and do some work in more traditional commodities.

The purpose of my statement is to emphasize to the committee that the Commission's definition of hedging needs to be revised and updated. This revision should be done by the Commission, in my opinion, and should focus on the new financial futures and options markets.

A revised definition is needed to reflect certain important and legitimate ways that financial institutions already are using these new markets. The hedging definition is important from a regulatory standpoint because it is the basis for making exemptions from the speculative position limits and because it is a requirement for institutional investors in order to obtain exemptions from certain registration requirements.

I would point out that the CFTC economic staff has recently done a very good baseline paper on the hedging definition, which I think would be useful as a starting point for this redefinition process.

Before the Commission was created, Congress had defined hedging in the act. However, in 1974 this responsibility was transferred to the new Commission.

In the words of the House committee report which the conference adopted "The goal of the committee in replacing the so-called mechanical test of hedging in section 4(a)(3) of the present act was to free the Commission to define hedging in a manner," and I emphasize this, "more consistent with the times and practices of the industry.

"It is not the intent of the committee that it be used to overly restrict industry use of the futures market for hedging."

The Commission carried out its responsibility by adopting a revised definition of hedging in 1977, 2 years after it was created. An important feature was an entirely new general or conceptual definition of hedging which intended to complement the specific itemized regulatory definition that had been in the statute.

Although the 1977 definition took some account of the new financial futures, which were still in their infancy, it was still primarily oriented toward agricultural and other physical commodity futures. Moreover, the definition did not even consider options, which are such an important part of the markets today.

The 1977 definition is still sound and adequate for commodity futures and also for many users of financial futures; but the definition is not adequate for all users and does not cover all valid uses. In particular, depending upon how the definition is interpreted, it may not recognize certain uses by institutional investors, such as pension funds and the mutual funds, or the investment advisors, bank trust departments, and insurance companies that manage such funds.

For these institutional investors, the advent of financial futures and options created a low-cost, efficient vehicle for managing existing portfolio investment risks and for adjusting a portfolio's risk parameters. Futures and options have also been instrumental in creating entirely new investment products and strategies.

I am pleased to say we have been involved with some of our clients in developing these new products.

Although some of these uses would clearly qualify as hedges under the 1977 definition, other uses simply would not. In particular, the 1977 definition refers to futures transactions or positions which normally represent a substitute for transactions in a physical marketing channel and where they are economically appropriate to the reduction of risk in the conduct and management of a commercial enterprise.

The words physical, reduction of risk, and commercial enterprise are simply not suitable for institutional investors in financial assets. These investors have a responsibility to make and implement decisions that require them to make choices between assuming various levels of risk in exchange for various levels of expected yield.

As an immediate remedy, I believe the Commission should make four specific changes in the 1977 definition. First, it should recognize the concept of prudent risk management by institutional investors in the general definition.

Second, under the enumerated definition, the Commission should recognize as a hedge long futures positions against holdings of cash or anticipated cash-flow. Such long positions should qualify on the same basis as short futures positions against assets already purchased.

Third, the Commission should be prepared to consider under the nonenumerated portion of the definition so-called synthetic securities that are heavily or totally dependent on futures or options positions.

Fourth, the Commission should complete its ongoing effort to incorporate options in the definition.

These modifications, at a minimum, are necessary if the full economic benefits of futures and options markets are to be realized. Otherwise, regulation will limit legitimate and valuable uses by institutional investors.

The hedging definition, as I already indicated, is important because it is the basis upon which institutions seek exemption from speculative positions limits and exchanges grant exemptions. A closely related rule is aggregation, which requires a combination of positions that are either owned or controlled by the same entity.

Aggregation should also be examined. For example, a pension fund's assets which are managed by a third party should not be aggregated with assets managed by the fund, itself.

Beyond the specific regulatory issues of speculative limit exemptions and aggregation, I believe the Commission should be in the forefront of articulating the essential economic functions of these new markets. In general, the Commission has a good record on that score and their contribution to the Government study, which was concluded about a year ago, is an example of that record.

But the Commission's definition of hedging needs to be expanded because it provides valuable understanding and guidance to many parties: To current market participants, potential users, to other regulatory agencies, to the Congress, and to the general public.

The concept of hedging has become synonymous with legitimacy. A narrow definition of hedging, framed for the agricultural commodities, will have the effect of foreclosing many market users from legitimate uses of the greatly expanded futures and options markets.

Unfortunately, the definition of hedging has not been updated in nearly a decade. It is time that the Commission devote its highly capable resources to this important task.

Thank you, Mr. Chairman.

Senator LUGAR. Thank you very much, Mr. Seevers.

[Questions submitted by Senator Helms to Gary L. Seevers, and answers thereto:]

Question 1. Options trading:

(A) The 3-year options pilot program is now complete. What factors of options trading, if any, should be examined further? Should options trading be expanded?

(B) If options trading is expanded, will the expansion consume significant Commission resources, over and above what is now used to support the regulation of options trading?

Answer 1. Options trading:

(A) I believe that options trading has been proven effective and the Pilot Program should be terminated by the end of the current fiscal year. Options trading should be regulated like futures trading in all respects. In particular, the number of options contracts should not be limited any more than that of futures contracts.

(B) Although additional options contracts and trading will require some incremental resources, I do not believe the amount will be be any greater than that required for additional futures contracts. Moreover, the main consideration should be the incremental economic benefits of more options trading. I believe that additional options trading will have at least as much economic value as additional futures trading.

Question 2. Approval of new contracts:

Some witnesses have compared the Commission's contract approval process with that of the SEC and have stated that the minimum time for CFTC approval of such contracts should be shortened.

Do you have any thoughts as to why one agency's approval process takes longer than another? What, if anything, could or should be done to remedy this situation?

Answer 2. Approval of new contracts:

The approval of new contracts by CFTC should be based on the sound criteria that have developed over many years, and not on criteria used by SEC. I believe that the futures markets have, on balance, benefited by a serious, diligent governmental review prior to the start of trading. While I recognize that bottlenecks have occurred, I believe it would be a mistake for CFTC to move to a rubber-stamp policy. A small percentage of new contracts succeed in practice and delays of a few months are insignificant compared with the long-term consequences if a contract begins trading prematurely and consequently becomes a failure. The potential economic benefits may then be lost for many years.

At the same time, I believe that the CFTC should not be permitted to "backburner" contracts indefinitely. The present timetable should, if applied by the CFTC in good faith, adequately balance the need for diligent review against the importance of letting the marketplace make the ultimate decision on the success of a contract.

Senator LUGAR. The Chair would like to recognize Senator Helms for questions that he might have of the witnesses.

The CHAIRMAN. I do have two or three, Mr. Chairman; and I thank you.

First of all, let me observe that I am glad to hear the report on how the agricultural options are working. I had a little something to do with that.

Throughout yesterday and today, Mr. Chairman and gentlemen, everyone testified that we ought to do better in the area of audit trails. I guess it is like Mark Twain and the weather: Everybody talks about it, but not much is done about it.

Do you have some specifics that you would like to tell me and put in the record?

Mr. DAMGARD. Well, Mr. Chairman, I think—and I touched upon it briefly in my testimony—that everybody—the exchanges, the CFTC, the brokerage firms—are all interested in continually improving audit trail. It is only when the exchanges believe that they are being asked to do the impossible do they come to the brokerage community and say, this is going to affect liquidity and execution for your customers and you should join with us in being as concerned as we are.

In that regard, it seems to me that there is concern, at the two large exchanges about the effects of time stamping on the trading in those tremendously busy pits where the transactions are taking place very, very quickly. I think that the CFTC has shown some flexibility yesterday in terms of Chairman Phillips saying that there may be some phase-in requirements. That might make sense.

But the system that Mr. Malamed described yesterday in some detail has not been rejected out of hand at all by the CFTC and we strongly support continuing efforts on the part of the exchanges and the CFTC to work on those systems which they believe, would answer all the concerns that the CFTC has.

We are anxious to continue to be a party to making that a regulatory event rather than burdening the legislative body with something so technical.

Mr. LAYTON. Mr. Chairman, I think that the exchanges are coming forth with some ideas and I think the two parties need to get together and bring these to a conclusion, and get the issue taken care of.

Effort has been made by the Chicago Board of Trade and the Merc in Chicago. I think those need to be brought through to a conclusion.

The CHAIRMAN. Mr. Chairman, my observation on this is that we have two sides, so to speak, both of them operating in good faith. I am certainly not derogating anybody, but I think there has to be more consultation and that sort of thing.

That sort of prompts another question. Suppose we simply recommended to the Senate that the Commission be reauthorized as is? How would that suit you?

Mr. DAMGARD. Well, I think from the FIA's standpoint, once these issues—particularly audit trail and maybe the capital rule, which are basically regulatory problems at the moment—are resolved, I suspect that we at the FIA would be very pleased to see a one-line reauthorization.

The CHAIRMAN. You think others in the futures trading industry would react in the same way?

Mr. DAMGARD. Well, I get in trouble when I try to speak for every element of the industry.

The CHAIRMAN. All right.

Mr. DAMGARD. But I would say that it would save an awful lot of time and resources; and I think I have zeroed in on two of the real concerns. We would want some assurance from the Commission that they would address some of the problems that Mr. Seevers and

Mr. Layton have mentioned about hedging definitions and raising the spec limits and that sort of thing.

But I think many of those things can be accomplished in the context of the current statute, and I compliment Congress in the past for having constructed a pretty effective agency.

The CHAIRMAN. How about leverage? What do you think of the Commission's proposal as to leverage?

Mr. DAMGARD. Leverage is not terribly important to our industry, I would say, at least not to my members; although a couple of years ago, there was some curiosity on the part of some of my members about getting into the business.

But at this moment I don't know of one FIA member that would be interested in getting into that business. The one or two firms that are currently in that business probably can speak for themselves, but it seems to me that it is awfully hard to absolutely abolish something that is in existence without creating an awful lot of enforcement problems.

I don't know how you get rid of a leverage transaction just by the stroke of a pen. Maybe they can alter their businesses in such a way as to meet the proposed requirements of the CFTC.

The CHAIRMAN. I would go back to the issue of options. I think they work pretty well.

Do you think they ought to be expanded?

Mr. DAMGARD. Very definitely, sir.

The CHAIRMAN. Do you want to elaborate?

Mr. DAMGARD. Well, I think the board of trade, in its testimony yesterday, pointed out that currently they are not even allowed to offer an option on wheat and that is the product that is grown universally, really, pretty much throughout the agricultural sections of the country.

It seems to me that the wheat farmers ought to have the same opportunities that the soybean farmers and the corn farmers have. With respect to the financial futures, I think that the CFTC has gone cautiously as the result of volume investors; but I really do think that that was an isolated incident and I think that the cure is in place and it is time for the Commission to expand both the financial options area and the agricultural options area.

Mr. LAYTON. We are operating under a pilot program and that should be made into a permanent situation and then go ahead.

We moved cautiously and we did not want to have any problems with it. I think the proof is there that everything is in place. So, if you feel strongly that it should be expanded, I think the wheat is a classic example.

The CHAIRMAN. Mr. Chairman, as you know, I was busy yesterday morning chairing another committee. We swapped committees yesterday.

Did the distinguished Chairman of the Commission address this issue in her testimony or through questions?

Senator LUGAR. Yes; as I recall, questions were raised on each of these issues; that she did not address it originally. A very good discussion ensued, particularly on the audit trail at the time because everybody was interested in that.

On the hedging definition question, I cannot recall whether she got into that; but I think that clearly has been raised today as something which she will need to get into.

The CHAIRMAN. Well, Mr. Chairman, so that we can move along, I would like to ask to submit some questions in writing and let Senator Zorinsky and Senator Melcher proceed.

Senator LUGAR. Very well. Thank you.

Senator Zorinsky.

Senator ZORINSKY. Thank you, Mr. Chairman.

Dr. Seevers, in your prepared text, you indicated that you recommend a change in the Commission's definition of hedging. Mr. Damgard also referred to it.

Could you elaborate on the problem of the current definition of hedging with your clients? Do I understand correctly you are requesting the Commission to take regulatory action rather than the Congress?

Mr. SEEVERS. Yes; I think this is a technical subject and Congress wisely, many years ago when it created CFTC, transferred the responsibility to define hedging to the agency and outside the statute. I think that should continue.

In terms of the problems that are created, I think one immediate problem is that options simply are not in the definition. The fact is that options are a major part of these markets today—I would guess 15 to 20 percent, and they could be 50 percent in 3 or 4 years—because they offer many advantages over futures markets.

So that is a clear omission. The significance of it is that exchanges are in the position that they have to grant exemptions or they have to consider requests for granting exemptions from speculative position limits, and the basis they use in doing that is the CFTC definition of hedging.

So, in some sense, they are really on thin ice when they grant exemptions for options positions. In fact, we have clients that have requested and obtained exemptions and their basic strategy in using options is one where the Commission staff has not necessarily looked into it. It is the so-called buy-and-write strategy of mutual funds. So that is one problem area.

I think that aggregation, which I referred to, is a problem because you may have, for example, a major insurance company that is managing assets and it may be managing them completely separately. Then because all the positions are under the control of the same insurance company their futures positions must be combined into one as if they were just one entity.

So, I think the aggregation rule is unduly restrictive.

Then my basic feeling of the major point of weakness in the hedging definition is that managers of assets are making decisions that involve constructive use of futures where the decisions really do not involve risk reduction. They involve using futures to make choices between assuming different levels of risk and different expected returns—take more risk and expect to obtain higher yields.

Futures are a low-cost vehicle. They can save pension funds and mutual funds money in terms of transactions costs for accomplishing some of these objectives which don't fall into a classic risk-reduction-oriented definition of hedging.

Senator **Zorinsky**. Have you had an opportunity to review the Commission's audit trail regulations?

Mr. **Seevers**. Not in detail. I have heard a lot about it, however.

Senator **Zorinsky**. If you were still a member of the Commission, what would be your views on the regulations?

Mr. **Seevers**. OK, I will put on that hat, with pleasure.

Actually, I chaired a task force in the early days of the Commission on what we called 1-minute time stamping at that time. The thrust was definitely toward the goal of being able to reconstruct the sequence of trading at a low cost without taking months or thousands of man-years to do so.

I think, unfortunately, the Commission backed away from that at one point 3 or 4 years ago, and I think it is good that they came back to it. I personally think that applying pressure to the exchanges has been productive and has made exchanges give that issue higher priority than they otherwise would have had; and I think the Commission, in some sense, should declare victory because I think the exchanges have been responsive.

They have come up with proposals that are improvements. I think the two Chicago exchanges' proposals, without studying them in detail, may be better than what the CFTC would impose on them under their rules.

So I think the Commission should declare victory, keeping in mind one thing: Whatever would be satisfactory today will not be satisfactory 5 years from now. Technology changes, the markets change, public expectations of what ought to be done change.

So it is an evolutionary process, the whole time reconstruction issue; but I think it is unfortunate that a line has been drawn in the sand on that issue and I hope that that line can be crossed over.

As I think Senator Helms said, there still should be an opportunity for dialog because I think the two points of view are really not that far apart.

Senator **Zorinsky**. Thank you, Mr. Chairman.

Senator **Lugar**. Senator Melcher.

Senator **Melcher**. Thank you, Mr. Chairman.

Mr. Layton, you mentioned the inherent optimism of cattle people when you were referring to cattle feeders.

Mr. **Layton**. Yes, sir.

Senator **Melcher**. And that many of the banks would require hedging before making a loan, which is easily understandable.

I was alarmed, when a cousin of mine who buys slaughter cattle, fat cattle, in the Midwest called me to tell me that the local PCA had decided there would not be any cattle-feeder loans, even with profitable feeders. After all, there are always some profitable feeders.

It wasn't a question of hedging. It was just a question of they wanted to get out of cattle-feeding loans, period. That very much alarms me, and that is a separate issue, one we will have to assess.

Just because cattle feeders have lost a lot of money, we don't want to keep those from doing business who have made some money and are willing to hedge. The question was not even hedging; it was just on feeder loans.

I used to feed cattle in the happier days. When you lost money, you generally lost $10 or $20 a steer; and, when you made money, it was likewise $10 or $20 a steer. Those were considered rather normal times.

Last year, I suspect many cattle feeders lost $150 a steer. I am not trying to reach the maximum. I think some probably lost even more than that, but it was pretty general, I think, last year that everything in the feedlot ended up losing anywhere from $50 to $100 a head—a substantial loss.

So in one respect, the issue we get into seems rather minor considering the overall problem of the livestock industry; but, nevertheless, we only have a bill that has to be acted upon dealing with a subject matter every few years and this happens to be one of the years.

Now, I used to buy and sell some futures contracts through the Chicago market on cattle, fat cattle. I think some of the problems that I thought put me quite remote from the pit have been better taken care of in past years than they were during the late sixties when I was involved.

My method was simply to call a broker in Denver and give him an order. He, in turn, had to contact somebody in the pit and place the order, buy or sell.

The audit trail was extremely important, first of all to the customer; of some significance to the brokerage house; and of great significance to the exchange itself.

What the Commission has been suggesting, as I understand their suggestion—which was not clearly enunciated yesterday by the chairman—has been something that would lead me to believe might be a step backwards. As an investor, if I were still dealing, I would want to have the quickest possible placing of the order and execution of the order—after all, it is my judgment versus whoever it is on the other side's judgment. I would want that to be regulated, and the audit trail is to regulate it and assure its honesty.

I am of the opinion that we are not going to pass any legislation touching on the Commission's authority to set this audit trail. They have broad authority now—and can require what they believe is essential.

We are not really dealing with the issue in writing some amendment to the existing statute that says, you will do it such and such. I don't want us to do that.

But, nevertheless, I want to see this resolved before this legislation gets away from this table. What the Commission had been proposing seems to me to be totally unworkable.

I just want your reaction to that because I view it as essential that we know what is going to happen before this bill is passed or we might find ourselves, as we frequently do in Congress, subject to existing statute and then a step backwards in the very thing where we are trying to move forward.

Mr. LAYTON. Senator, since I was born and raised on a farm in Illinois and we still have family farmland in Illinois, I could not expand on what you said. You said it all and that is exactly where we would be coming from.

The alternatives have been provided by the Chicago Mercantile Exchange and the Chicago Board of Trade to try to work out this thing. The CFTC needs to get together with them; they need to get the thing done.

You have said it all.

Senator MELCHER. Thank you, Mr. Layton.

Senator LUGAR. Thank you very much, Senator Melcher. Let me indicate without entering into this argument that has been settled so amicably, it appeared to me at the hearing yesterday it would probably be useful in having a conversation in a public way. I know that it has occurred privately between the groups that have been mentioned.

It appears to me that the CFTC is working in good faith with private persons to see what might be practical and that there is a timeframe in which this might occur. All the parties are eager to use that timeframe to advantage.

My hope is that during the course of these hearings that there will be some report forthcoming. Senator Dixon, I might add, came this morning. I might ask unanimous consent to put his statement in the record because he appeared at this hearing, and also that of Senator McConnell.[1]

He also wanted to report yesterday in behalf of his constituents, in Chicago, and he was in fact joined by all Senators. So I simply offer that word of reassurance that we hope to see resolution of this.

We appreciate the testimony of each of you gentlemen this morning and the reappearance of Dr. Seevers in another role who has taken part in these reauthorization hearings in the past.

Thank you very much for coming.

The Chair would like to call now a panel including Warren W. Lebeck, a member of the executive committee and board of directors, National Grain Trade Council of Westmont, IL; Dr. David C. Lucterhand, president, the Lucterhand Group of Chicago, IL; and Joe Cramblit, president of Geldermann, Inc., Chicago, IL, representing the National Grain & Feed Association of Washington, DC.

Gentlemen, it is good to have you here at the table this morning. As I mentioned to our previous witnesses, we would like for you to summarize your initial presentations into 7 minutes or less with the understanding that your full statements will be made part of our hearing record for the study of all members.

I would like to ask Mr. Lebeck to begin his testimony, and then to Dr. Lucterhand, and then to Mr. Cramblit.

STATEMENT OF WARREN W. LEBECK, MEMBER, EXECUTIVE COMMITTEE AND BOARD OF DIRECTORS, NATIONAL GRAIN TRADE COUNCIL, WESTMONT, IL

Mr. LEBECK. Thank you, Mr. Chairman and members of the committee. My name is Warren Lebeck. I hasten to add that while Westmont, IL, is one of my homes, I assured the chairman of the full committee that I came up here from Pinehurst, NC.

The CHAIRMAN. Very good.

Mr. LEBECK. Senator Lugar, I have a son who lives in South Harbor, Noblesville.

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[1] See pp. 306-307 for the prepared statements of Senators McConnell and Dixon.

The CHAIRMAN. You have hit all the bases.

Mr. LEBECK. Not all. I cannot do much for Senator Melcher.

I appear before you today representing the National Grain Trade Council. I am a member of the council's board of directors and executive committee. After listening to yesterday's testimony, I have made a few changes in what we had submitted for my oral statement.[1]

The council is a national trade association whose policymaking members include grain exchanges, boards of trade, and national grain marketing associations. Those who represent these organizations on the council are all users of the agriculture futures markets.

As users of the markets, they are vitally interested in how the markets function and how they are regulated. Consequently, the council appreciates this opportunity to appear before the committee to present its views on the CFTC.

We support reauthorization and feel the term should be for at least 6 years so long as current differences of opinion are worked out. We favor the recommendation that the contract approval process be shortened from 1 year. Agricultural options have proven their usefulness and should be opened up.

With regard to leverage contracts, the CFTC should be limited to regulating contracts that are traded on licensed contract markets.

One of the serious problems for users of agricultural futures is the lack of trading in the deferred contracts primarily as a result of recent tax changes. Commercial users of the markets have been harmed by this lack of liquidity, which also reflects itself unfavorably in prices to producers.

The tax situation should be looked at. In addition, the raising of speculative limits could have a positive effect, principally through encouraging funds to take a more active part in the deferred contracts.

The council supports the CFTC's legislative proposal to eliminate the automatic stay of NFA disciplinary actions through an appeal to the CFTC. The council, however, does oppose the CFTC recommendations for more power over NFA's rules.

By their own admission, NFA has worked well to date. Thus, additional authority is neither needed nor justified.

For council members, as users of futures markets, the economic viability and utility of the markets is of the utmost importance. There is a natural concern about the capitalization of exchange member firms, yet experience in the agricultural markets has been exemplary.

The manner in which the agricultural futures markets handled the volatile 1973 markets, when grain prices reached alltime highs, and the manner in which these same markets handled the financial problem occurring at practically the same time as the volume investors situation leads the council and its members to have great confidence in the experience and professionalism of these markets and their ability to handle financial difficulties.

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[1] See page 318 for the prepared statement of Mr. Lebeck.

The CFTC proposals would appear to further concentrate the business in fewer and fewer hands, which could only lead to greater risk should there be a problem. It is clear that had present rules and procedures been followed in the volume investors situation, the problem might not have occurred or, at least, would have been greatly minimized.

Quite frankly, it appears that the CFTC has reacted with an axe when a scalpel in the hands of those skilled in these matters would have sufficed. What is needed is a properly constructed capital rule carefully drawn with inputs from those who have successfully weathered financial storms.

Members of the council are also, of course, concerned that the orders be handled correctly on the floors of the exchanges; but they are more concerned that their orders be handled expeditiously. In active markets, a delay of even a few seconds can mean missing the market or getting a much less satisfactory fill.

The Commission and its staff seem to have ignored the economic impact that their proposal will have and have most certainly ignored studies submitted by the Chicago Board of Trade while having made no comprehensive studies themselves. The refusal of the Commission to take into account the consequences of its proposal and its effect on the public interest or even to listen is disturbing to those who use the market and will be affected by such shortsightedness.

It interested me that the Chairman of the Commission, yesterday, acknowledged that most transactions are handled properly. Why, then, risk upsetting functioning markets?

The Chairman also said one reason for their audit trail proposal was allegations of price manipulation in the 1983 grain markets. I fail to see the connection between manipulation and the broker racing an order.

The allegations of manipulation were leveled against the suspicion that large firms had made large speculative trades to influence price. Even an absolutely perfect audit trail would have told you nothing of the intentions of any such orders.

I would also like to describe for you a scenario not mentioned yesterday. A broker has a dozen or more stop orders in his deck all triggered by the same price. That price is reached. There are 12 orders or more to execute as rapidly as possible; and you heard yesterday that that could mean many more than 12 separate transactions.

Does the broker time record each separate transaction? Does he record what is done within each minute? Or does the broker execute all the stops and then record? And what about a market order that comes in while he is executing these stops?

One also wonders if the CFTC has considered the fact that its proposal seems to give any broker an automatic excuse for unsatisfactory fills: "Sorry, I was time-recording executed trades when the market moved."

This leaves council members and other users of the market faced with a dilemma: Which is the greater threat, the possibility that an order will be mishandled or the reality that 1-minute time recording will delay execution?

After reviewing the audit trail proposal submitted by the Chicago Board of Trade and the Chicago Mercantile Exchange, the council and its members are convinced that these give adequate protection against possible abuse without having to disrupt market activity.

One final comment. When reviewing the performance of the CFTC, I am reminded of the definition of an economist I have heard. Sorry, Gary.

An economist is one who observes something that works and then spends time wondering if it will work in theory.

Any comments about the CFTC in this testimony are intended to be constructive. There is no need to merge the CFTC with any other agency.

What is needed is more appreciation by the CFTC of what the markets do and more appreciation for the experience of those who have kept their markets functioning successfully lo these many years. A little more responsiveness to the industry is all that is needed.

One final thing. I had an opportunity this morning to review the testimony that Mr. Cramblit is going to give. They touch on several things that we have passed over or have not even mentioned, but I would support what he says wholeheartedly.

Thank you, Mr. Chairman and members of the committee, for the privilege of presenting our views.

Senator LUGAR. Thank you, Mr. Lebeck.

Mr. Lucterhand?

STATEMENT OF DAVID C. LUCTERHAND, PRESIDENT, LUCTERHAND GROUP, CHICAGO, IL

Mr. LUCTERHAND. Good afternoon and thank you for this opportunity to appear in front of your committee. My name is David Lucterhand and I am president of the Lucterhand Group. It is a private merchant bank and I am appearing here today as a member of Lucterhand, Small & Associates, a partnership specializing in commodity finance.

Personally, I am a graduate of Purdue, did graduate work at the East European Institute at Indiana specializing in the education of the Soviet military elite, and postgraduate work in Europe.

Senator LUGAR. A remarkable background.

Mr. LUCTERHAND. Also, however, I have been a member of the Chicago Board of Trade and the Chicago Board Options Exchange for 12 years.

Recently, we have been working with the European Community to find alternate ways to fund their common agricultural policy. These activities, coupled with the internationalization of the world economy and a perception of agriculture as an instrument of national power, led us to the development of an alternative price support system which we brought to Congress in August 1985.

Now that Congress has authorized the Secretary of Agriculture to begin a pilot program to determine the feasibility of an alternative approach using the private sector, we should like to address the role we see the CFTC playing as the process of implementing the pilot begins.

Since 1933, Congress has been approving farm legislation to provide income support for producers. While various features of this legislation have been refined over time, the fundamental aspects of these farm programs have remained the same.

The current and past U.S. farm programs have relied on Federal price support loans and deficiency payments based on acres set aside from production. By complying with the program requirements, the farmer obtains the right to receive a loan from the Government by using his harvested grain as collateral.

If the price during the season after harvest does not exceed the loan level, the farmer simply forfeits his grain to the Government. Thus the Government accumulates huge stocks of surplus grain which are held out of marketing channels until prices, hopefully, in the future, rise above the loan level.

These price support operations have been expensive. A total of $11.2 billion for corn, soybeans, wheat, and cotton was made in fiscal year 1985. As of January 22, 1985, over 5.6 billion bushels of corn, soybeans, and wheat and 6.7 million bales of upland cotton were under the direct control of the CCC price supports.

Additionally, price supports have reduced the ability of the United States to compete in international grain markets. The U.S. share of world trade in grains, peaked at 60.1 percent in 1979, now stands at about 50 percent.

While the 1985 farm bill still relies on price support loan programs, a new section of the farm bill has opened up a door of opportunity to make greater use of the private sector resources while still providing farmers with price stability and income protection.

Specifically, the farm bill directs the Secretary of Agriculture to conduct a study, with the CFTC, to determine how producers might use agricultural futures and options markets to protect their farm income. In connection with this study, the Secretary of Agriculture will conduct a pilot program in at least 40 counties for wheat, corn, soybeans, and cotton to determine how futures and options can be used as a substitute for the price support loan program in providing price stability and income protection to U.S. producers.

Most importantly, this pilot program will feature an extensive educational effort on price-risk management by the USDA, CFTC, and futures and options industry. While the details of the proposed pilot program remain to be worked out, the basic scheme would rely on the indirect use of exchange-traded agricultural options by farmers.

As is the case with the current farm program, a farmer will sign up for the proposed program at the local ASCS office by agreeing to comply with program requirements. However, in lieu of being eligible to receive a loan from the Government for his grain, the farmer would be eligible, if he so desired, to received from the USDA a warrant guaranteeing him the loan price for the grain.

The farmer would be able to cash in his warrant any time during the year for the difference in the cash price and the loan rate; and, thus, the farmer's price for his grain would be supported at the loan level no matter how cash prices change during the marketing year.

As is the case with Treasury bill auctions, the USDA could utilize a Federal dealer pool to provide these warrants to the farmers.

Members of the Federal dealer pool could hedge their warrant commitments in exchange-traded options or futures, or in the cash market for grains.

The proposed program is designed to replace only the commodity loan price support feature of the current farm program; however, this alone could be the first step in getting the Federal Government out of the expensive grain storage business and reducing grain surpluses by allowing grain to be moved at market-clearing prices. This would put U.S. grain back into world marketing channels and all other features of the current program—deficiency payments, diversion requirements, and payment, disaster, et cetera—would remain the same.

Since approval of a pilot program for agricultural options by the Commodity Futures Trading Commission, agricultural options contracts in soybeans and corn have been initiated at the Chicago Board of Trade. Between November 7, 1984, and January 22, 1986, the average daily trading volume for soybeans options rose to over 15 million bushels. Between February 27, 1985, and January 22, 1986, average daily trading volume in corn options grew to 10 million bushels. In spite of severely depressed conditions in all agricultural trading, soybean and corn options have performed as well or better than any other new commodity options contract introduced to date. Even though the absolute level of volume in U.S. Treasury bond options has been higher, the volume of options as a percentage of the underlying futures has been higher for soybeans and corn options over a comparable period of time. If soybean options and corn options can do this well under extremely depressed agricultural trading conditions, there is an obvious demand and need for these options by the agricultural community.

Since Congress authorized trading in agricultural options in 1982, agricultural options have been trading since October 1984. During this time, in spite of concerns about this new technology, exchange-traded agricultural options have had an unblemished record.

Trading of agricultural options has demonstrated their usefulness. By using agricultural options, farmers and grain merchants have been able to establish a minimum price for their commodities.

If the commodity's selling price has increased relative to this minimum price during the life of the option, the farmer has had the ability to take advantage of the higher selling price.

The current agricultural options pilot program established by CFTC, however, allows only two agricultural options per exchange. While there has been favorable public comment to a February 18, 1985, petition by the National Wheat Growers to expand the number of agricultural options from two to five per exchange and repeated petitions by the commodities industry, the program has not been expanded as has been the case for the nonagricultural options pilot program.

An expansion of the agricultural pilot program at this time is not only desirable to help the farm sector manage price risk, but would also help the CFTC's evaluation of agricultural options and facilitate the farm pilot program study.

In conclusion, a congressional mandate to develop this pilot program represents a bold step by Congress to substitute private sector technology for traditional Government price supports as a way to provide farmers with income protection. This approach, which relies upon risk-transfer instruments developed by private enterprise, is an experiment which will require the cooperation of the USDA, the CFTC, the commodities futures industry and agriculture producer associations.

For the first time, we stand on the threshold of an opportunity to get the Government out of the grain business; begin the transition to a free market in grain prices while maintaining price supports at current levels with predictable and less cost to the Government.

The implications of no longer having the Government in the loan program will mean substantial savings, price levels that will stimulate demand, and allow us as a nation to recapture what was once 60 percent in market share and even increase it.

We commend Congress for creating this opportunity to try out new ways to use private sector resources and technology to replace costly Government programs. We eagerly look forward to working closely with the Department of Agriculture, the CFTC, and agriculture producer associations to help carry out this congressional mandate.

Thank you.

Senator LUGAR. Thank you very much, Mr. Lucterhand.

Mr. Cramblit. You are next.

STATEMENT OF A. JOSEPH CRAMBLIT, PRESIDENT, GELDERMANN, INC., CHICAGO IL, REPRESENTING NATIONAL GRAIN AND FEED ASSOCIATION

Mr. CRAMBLIT. Mr. Chairman, members of the committee, I appreciate being here today. My name is Joseph Cramblit. I am president of Geldermann, Inc., of Chicago, IL. I am also a member of the Chicago Board of Trade.[1]

Geldermann, Inc., is a member of the National Grain and Feed Association and I am presenting this statement on behalf of that association. We appreciate the opportunity to express our views regarding S. 2045, the reauthorization of the Commodity Futures Trading Act.

The U.S. grain industry is proud of the role it played in the development of the commodity futures markets. The National Grain and Feed Association believes it has been a constructive, positive force during this development and growth process.

It is a matter of record that this association has been a responsible, cooperative counselor to the Congress and other branches of government, and has aided government as it has considered legislation and regulatory proposals pertaining to this marketplace.

Continuation of viable futures markets is critical to a competitive and efficient marketplace for agriculture. The price discovery mechanism provided by the futures markets benefit the entire Nation's economy as it ensures fair prices are offered to both producers and consumers alike.

Just as important to the smooth functioning of a competitive marketplace is the risk-management mechanism provided by futures and options markets. Without the opportunity to shift risk via these markets, commercial interests would be unable and/or unwilling to offer many of the marketing services available today. And the cost of providing marketing services would be substantially greater in the absence of futures markets.

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[1] See p. 320 for the prepared statement of Mr. Cramblit.

Futures markets are truly the cornerstone of the efficient marketplace. The National Grain and Feed Association believes that the Commodity Futures Trading Act of 1982 has served the industry well. We further believe that the current legislative extension process should be confined to management-type improvements in the existing law rather than the adoption of sweeping new legislation.

This association strongly recommends that the regulatory agency, the Commodity Futures Trading Commission, continues to be an independent agency. We believe, as we have believed since the creation of the CFTC, that all futures markets should be regulated by an independent regulatory body. We recommend that no substantial change be made in the act as it relates to the jurisdiction of the CFTC pertaining to futures markets.

While not under active consideration, the issue of margin-setting authority being vested in one or more Government agencies remains a primary concern for our industry. It is also our firm belief that margins on futures contracts should continue to come under the sole purview of the individual futures exchanges.

We do not believe any Government agency, no matter how enlightened or well intentioned, possesses the capability to manage the margin responsibilities for futures markets. We do not believe any Government agency could be sufficiently responsive to changes in marginal levels that frequently must be effected in an environment of fast-breaking changes that necessitate rapid, immediately implemented decisions.

In our judgment, only the individual exchanges have the capability to deal with logistical realities of margin-setting responsibilities regardless of the underlying commodity.

Under the current act and regulations cash-forward contracting is not regulated by the CFTC. Encumbering the efficient grain marketing place with Federal regulations would only distort the responsive nature of the grain market's purchaser and seller needs.

The National Grain and Feed Association strongly recommends that no added provisions to the regulation of cash commodity forward contracting be included in the extension of this regulation.

One of the most significant changes in the futures exchange activity authorized by the Commodity Futures Trading Act of 1982 was the pilot program for agricultural options. This program has been highly successful.

Although limited in scope, options contracts for agricultural commodities have provided producers and commercial hedgers many new alternatives for hedging their risks. Producers, commodity buyers, elevator operators, processors, and exporters have just begun to realize the vast potential uses of options and the innovations and opportunities it will bring to marketing and purchasing commodities.

As price supports, offered in Government programs, are adjusted to allow the United States to compete in export markets, producers will find options markets provide them with new alternatives for developing production and marketing strategies. Options, offering a guarantee of a minimum price without limitation on potential gains from market rallies, may become increasingly attractive to producers and hedgers during the coming growing season.

Based upon results of the pilot program and options, we would support an expansion of this current program.

The application of options in commercial channels has had an impact on cash-grain contracting resulting in an expansion of the types of cash contracts offered producers by buyers. Through these new cash contracts, additional producers have realized benefits from the new options markets.

In an interpretative statement published in the September 30, 1985, Federal Register, the CFTC confirmed its view that these new cash contracts were forward-cash contracts and not subject to CFTC jurisdiction. We agree with this conclusion and we commend the CFTC for clarifying its viewpoint for the industry.

We recommend that the Commodity Exchange Act, as amended, be extended for a period of 6 years. The National Grain and Feed Association desires to be helpful to the Congress as it considers this reauthorization legislation.

Please do not hesitate to contact the National Association regarding any questions whatsoever your committee may have on this overall subject.

Senator LUGAR. Thank you very much, Mr. Cramblit.

Senator Helms, do you have questions of the witnesses?

The CHAIRMAN. I think no. I will defer.

Senator LUGAR. Senator Melcher.

Senator MELCHER. Mr. Lebeck, do you think there ought to be a wheat option?

Mr. LEBECK. Well, there are wheat options, sir; traded on other exchanges. The Chicago Board of Trade, which is the largest wheat futures market, because of the restriction of two does not have one.

Senator MELCHER. Well, do you think there ought to be additional wheat options?

Mr. LEBECK. With all due respect to the Mid-America, Kansas City, and Minneapolis, together they don't come anywhere near the type of volume or don't have the facilities, financial backing, and the speculative interest that the Chicago Board of Trade does. That would give wheat producers and users of those markets much more liquidity; and, I think, probably better market execution.

Senator MELCHER. So you are in favor of it.

Mr. LEBECK. Yes, sir; very much so.

Senator MELCHER. Do we need a pilot program?

Mr. LEBECK. Well, we have had a pilot program. As both of the gentlemen here with me and the ones before have said, it has been successful. There have been no problems.

I think the exchanges, all of them, have proven that they can handle it and it is time to take off the restrictions.

Senator MELCHER. What about wheat growers? Do they want one?

Mr. LEBECK. I think that the wheat growers have requested that the restrictions be taken off; and since they are at other exchanges, obviously, they are asking that the Chicago Board of Trade have one.

Senator MELCHER. Thank you, Mr. Lebeck.

Mr. LEBECK. You are welcome, sir.

Senator LUGAR. Mr. Lucterhand, would you describe a bit more the pilot project summarized in your testimony in which a farmer who has grain and who wants to store it now tries to obtain a loan and, under the proposal may be a part of this pilot project?

He would, in fact, receive a warrant. Now, you have suggested he would be able to sell this warrant at any time and what he would receive for it would be determined on the difference between the loan rate and the market price at the time.

Can you just take us physically through this process? For example, when the harvest comes and he has 1,000 bushels of corn, does he sell the corn? Does it go into the market at harvest time?

What happens to the corn and how does this affect the storage situation, quite apart from the instruments, the loan or the warrant?

Mr. LUCTERHAND. Senator, it depends. The one thing you have to understand about this proposal is that it takes a leaf out of the way of the current Treasury auction functions in that we are proposing, first of all, a marketplace in which we will have Fed agricultural dealers, very much like we have participants in the Fed now. There are 36 primary.

We don't know how many we will need, but there will be sufficient numbers of them to provide liquidity.

The way it is currently evolving, since the authority was given to the Secretary to begin this pilot, is that these Federal dealers will initiate, at the request of USDA, *x* amount of warrant depending on volume. Now, remember, we are only dealing in 40 counties at this point so it's not a grandiose plan.

The way it will work is that, if you would physically like to know, let's say, at 9 in the morning the USDA will issue a tender for how many warrants they need, based on how many farmers they have signed up at these ASCS offices. By 10:30, the Federal dealer pool will respond with their bids and asks on the screen—it is a simple screen—and the USDA will, on a competitive basis, take the best price for those warrants and now have those warrants, which they will then issue through the ASCS office to each individual farmer. The farmer now has this warrant.

This warrant may even have his Social Security number on it so it is not transferable amongst farmers. There won't be trading of warrants back and forth. This will only be refundable back at the ASCS office who, in turn, will do the reverse process to check the bid and ask the following day and refund it, if you please.

There will be certain callable provisions in which the Federal dealers will trade among themselves to provide liquidity very much like they trade now for the Treasury auction.

The farmer, at harvest time, goes in with his warrant. Let's say we have the loan price at $2.56 for corn, and let's say corn is trading at $1 when he goes in to sell it.

Now, the USDA has issued this warrant to him and they have prepaid for it. So, one, you know how much up front your out-of-pocket risk will be. The Government will never have to worry about where the price of this thing will go once they have purchased the warrant.

This is done on a competitive basis through the year, the pricing, even though we have a time value here of maybe 9 months or so when the Government will begin the process of estimating its needs as to how many warrants it will need. So we are not talking about the Government going out and spending $1.56 for its warrant, but perhaps on our projections we are looking at the Government maybe spending 42 or 43 cents a bushel a warrant, on 5,000 bushels in essence.

So, at this point in time, we have not defined, if you please, just how far if we are going to deal in odd lots: 1,000 bushels, 100 bushels. That is under development.

But at harvest time if corn is trading at $1, the farmer at his election can do one of two things. He can turn around and sell his corn at $1 in the open marketplace and take in his warrant, and get the difference; or he can take his warrant, if he pleases, and borrow against it at his local bank, which is nice because now they have a U.S. Treasury piece of paper as collateral as opposed to what is some price in the farmland, which you have no idea what it will be if it's in loan, and if it's in loan, he doesn't need to borrow.

So we have accomplished a couple of things here in helping to establish the integrity of the banking system somewhat better than it currently is.

In effect, the farmer, if he wants to speculate—and farmers do do that; in fact, the Government speculates every day by being at risk with this loan program—can keep his grain and not sell it if he doesn't like it, and thinks that perhaps grain will rise up to $2 or whatever.

But the main thing to remember is that he has his guarantee at $2.56. Under this program, he is not going to ever be putting his grain into loan. So the Government gets out of that very expensive problem of what to do if it never gets above $2.56 and he forfeits it.

At this point we have, in essence, created the transition to a free market on that basis. I could go into more detail.

Senator LUGAR. But the storage call into the Government is eliminated.

Mr. LUCTERHAND. That is correct.

Senator LUGAR. Now, if I followed the description that you had, warrants are based upon the acreage base and bushels. In other words, the farmer, under whatever plan the Secretary of Agriculture devises—let's say that he can plant 80 percent of what he planted last year and he has a history of 100 bushels for those acres—the Federal Government has an idea of its potential obligation.

This is presumably the basis on which the warrants are going to be sent out to the farmer.

Mr. LUCTERHAND. That is correct.

Senator LUGAR. So that the Government, then, all along is defining its potential obligation. In all of these auctions, day by day, it accumulates the warrants. At some stage, it had to put out money for warrants knowing that at some point a farmer is going to have 100 bushels of corn and a warrant, and he can exercise that.

You mention a timeframe. The Government is buying these warrants all along getting ready for the harvest?

Mr. LUCTERHAND. Well, the way we see this, farmers will be signing up during the course of the year from the signup period.

Senator LUGAR. I see.

Mr. LUCTERHAND. The first time, because we have to have a starting time, will be at the beginning of the actual harvest. The most optimum time, if you will, could be in October of this coming year to start the first ones, and then after that we would have a continuous buying on the part of the Government being able to anticipate its needs. It would be a quantifiable number up front.

Might I also say, if I could, in terms of cost there is a very easy way to recapture some of the cost to the Government in terms of the warrant, and that is simply by expanding this pilot a little further and selling, if you please, calls or selling warrants against CCC storage.

I might say this is what we proposed to the common agricultural policy. They are looking at it right now in terms of recapturing revenues. Nations such as Germany have passed special taxes, as you well know, specifically earmarked to create revenues to subsidize this common agricultural policy.

But I would much prefer if this Nation took the lead in selling calls or what we call covered writes—a simple securities transaction in which you sell warrants—to the public or through this Federal dealership, however you care to do it, and bring in money which then could be applied against the cost of actually buying these warrants.

We have all this grain sitting out here wasting away, rotting every day as we sit, getting less and less of worth to anyone. That way, by selling warrants against it, you can produce income.

Senator LUGAR. Well, that is a very important idea. You say USDA is entertaining this now? The Department of Agriculture is studying this idea?

Mr. LUCTERHAND. The Secretary has mandated and set up a policy study committee with producers, processors, exporters, and futures and options traders to work in tandem to develop a program. That is ongoing at this point in time.

Senator LUGAR. Now, on the 40-county situation as somebody who is active in this field, has the procedure started yet for those 40 counties in America?

Mr. LUCTERHAND. It has only started informally. I have gone to certain counties in Indiana, I might add, and talked to producers there as well as local county agents just to determine mechanically how it will impact on how they do business; but, right now, it is still at the secretariat stage, quite frankly. It has not gotten that detailed yet.

Senator LUGAR. I think this is an ingenious way of trying to get the Federal Government out of storage and maybe, as the witness has suggested, trying to get some money for these enormous stockpiles that we now have to offset some of the cost of our agricultural bill that we have here.

The CHAIRMAN. Mr. Chairman, may I ask a question?

I believe you recommended a 6-year authorization.

Mr. CRAMBLIT. Yes, sir.

The **Chairman**. We also had, as I understand, a recommendation for a 2-year reauthorization. Would you say a few sentences in defense of the 6-year period?

Mr. **Cramblit**. Well, we feel 6 years is important. It is almost a minimum amount of time for a commission to get anything done; to get programs going. It provides some continuity for their supervising of futures markets, new contracts, whether it is audit trails or options contracts or whatever. They need some time.

We think 6 years is a right amount of time; 2 years, in our personal opinion, is just not enough.

The **Chairman**. Well, Mr. Chairman, I asked a leading question on purpose. I am sitting in a chair where for so many years the distinguished Senator from Mississippi, Mr. Eastland, sat. He passed away yesterday, as you know.

He told me a couple of years ago, after he got out of the Senate—I tried to call him every 2 or 3 weeks just to see how he was doing.

Did you ever know him?

Mr. **Cramblit**. No. I know of him, of course.

The **Chairman**. Well, he was a character and a good Senator.

He said, I am damn glad I am not on the Agriculture Committee because you have all these things you have to reauthorize. It seems like every month they come around.

He would have enjoyed your statement. Incidentally, I appreciate—and I know Senator Lugar does—your comments about the farm bill. It is not as much as we wanted in terms of moving back toward a free market, but there is some awfully good policy in that 1985 farm bill that you will see the results of as we move along.

Senator Eastland told me, I think the last time I talked with him, that the longer he had been out of the Senate the more convinced he became that we had just made a mess of agriculture in Washington, DC. Here is a man who had interests in specific commodities, particularly cotton; but he said that these programs had had their impact on cotton and he said, "I see that now".

But Thad Cochran, Senator Cochran of Mississippi, and I were in a colloquy yesterday paying our respects to Senator Eastland and Senator Cochran said that on one occasion Senator Eastland and another distinguished Senator from Florida, Senator Holland, had been down to Atlanta, as I recall, at some sort of farm meeting, and they were flying back into Washington at night.

As they approached Washington, they saw all the lights. Senator Holland turned to Senator Eastland and said, "Jim, you realize that we are looking down on the most powerful city in the world?" Senator Eastland said, "I reckon so."

Senator Holland said, "Just think, Jim, you and I are in the center of that." Whereupon, Senator Eastland said, "Are you drunk?" [Laughter.]

You have to have known Senator Eastland intimately to appreciate that.

Mr. **Chairman**. I just have a comment: The witnesses I heard yesterday and the testimony I read of those whom I did not hear—and we have had two panels thus far this morning—have made a fine contribution. I just want you to know that I appreciate it.

I know you have spent a good deal of time preparing and coming here, but this is what the process is all about and we appreciate it.

Thank you, Mr. Chairman.

Senator LUGAR. I add my own appreciation to that of the chairman. We are, indeed, grateful to you.

You are dismissed if you wish to be, and we will proceed with the next panel.

The Chairman. I have just been handed a note. If Mr. Lucterhand would send us something in writing detailing his proposal, we would be glad to receive it. We won't need it for the record, but we would like to study it.

Mr. LUCTERHAND. Yes, sir. We will get it right to you.

The CHAIRMAN. If you would, I would appreciate it.

Mr. LUCTERHAND. Yes, sir.

The CHAIRMAN. Thank you.

Senator LUGAR. The Chair would like to now call a panel of Theodore Thomte of the National Association of Futures Trading Advisors, Bedford, NY; Robert Isaacson, chairman, government relations, National Association of Futures Trading Advisors, Menlo Park, CA; and Phil Feigin, chairman of the commodities committee, North American Securities Administrators Association, Denver, CO.

Good morning.

STATEMENT OF THEODORE THOMTE, PRESIDENT, NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS, BEDFORD, NY, AND ROBERT L. ISAACSON, CHAIRMAN, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS, MENLO PARK, CA

Mr. THOMTE. I am Ted Thomte. Mr. Isaacson had to attend another meeting. His remarks and mine are combined.

Senator LUGAR. Very good. We are pleased to have you. Mr. Thomte, would you please proceed with your testimony.

Mr. THOMTE. Yes, sir.

My name is Ted Thomte. I am president of the National Association of Futures Trading Advisors, NAFTA. NAFTA is the national trade association in the futures trading advisor area. Our members are approximately 175 in number and we manage about $800 million commodity investments for over 5,000 clients.

Our members are active as commodity trading advisors and commodity pool operators, and they operate or advise a substantial number of the pools and managed accounts currently in existence.

Our segment of the futures industry is a relatively new one, but it's growing rapidly. We welcome the opportunity to report to the committee on our experience in operating under the current regulatory structure.

We wish to commend the efforts of the CFTC and NFA in regulating the industry, including our own highly specialized segment.

In our opinion, these agencies have demonstrated competence and professionalism in coordinating their regulatory programs to the benefit both of the public and the industry. We are especially appreciative of the CFTC's action in designating a special counsel for regulatory matters affecting pool operators and trading advisors, an action we believe generally symbolic of the CFTC's recognition of the highly specialized nature of our field.

We are also pleased to report that the National Futures Association has met the expectations of our membership regarding self-regulation. The development of NFA and its assumption of growing responsibility have, to a great extent, made regulation more efficient, more protective of the public interest.

It has been our experience that the registration staff at NFA has been accessible and knowledgeable. NFA has developed streamlined procedures that have made the registration process more efficient and less expensive for the industry.

To go on to arbitration matters, the development of the NFA arbitration program is another promising aspect of the NFA's growth. The NFA arbitration system has been in operation for almost 3 years and we believe this forum for dispute resolution has provided a popular alternative to litigation and arbitration in other forums.

My main remarks about NFA deal with the audit and education section, a third area where they have accomplished a great deal. NAFTA is particularly interested in the audit program because it constitutes the primary mechanism for overseeing compliance of pool operators and trading advisors with CFTC and NFA regulations.

Although this audit function could be performed with only a narrow focus on enforcement, NFA audits have concentrated on member education as well. Many NAFTA members are relatively small pool operators or trading advisors. These members have been assisted by NFA staff in implementing changes in recordkeeping and reporting procedures, and in modifying their disclosure documents to conform with applicable CFTC and NFA regulations.

NAFTA believes that an essential element of industry self-regulation is education of the members as to their regulatory and compliance responsibilities because a large percentage of technical violations arise from incomplete understanding of applicable rules.

As a membership organization, NFA's assistance to its members and to the public will be enhanced by counseling members of NFA on matters related to regulation and compliance. We believe that a good start has been made in that area and should be built upon and expanded. NAFTA specifically wishes to acknowledge the assistance received by NAFTA members from NFA staff in developing and improving their compliance procedures.

The NFA staff deserves praise for the recent completion of a special compliance guide for trading advisors and pool operators. This guide is written in plain language and, at the same time, gives detailed helpful compliance guides.

A fourth area of NFA accomplishment concerns the development of highly professional ethical standards for our segment of the futures industry, and that includes an effective industry-wide rule for discretionary accounts, an advertising rule which governs both the form and content of promotional material, and the development of a know-your-customer rule that focuses on customer understanding of the relationships of his trading objectives and the risks of trading in commodity interests.

These examples of NFA performance underscore a development viewed by NAFTA as having even more importance in the long run: The development of an effective working relationship between

NAFTA and the industry characterized by a high degree of mutual respect, a willingness to understand conflicting viewpoints, and a desire to accommodate to them where possible.

NFA accomplishments, since its inception, have been made possible by a working environment conducive to effective self-regulation.

Finally, we wish to comment on several specific issues that have been raised in the course of these hearings. We support the CFTC's proposal to extend the period between congressional reauthorizations of the agency to 6 years from the present 4. We believe a 6-year reauthorization period would contribute to regulatory efficiency by conserving the resources of the CFTC, the industry and the Congress.

We also support several measures designed to strengthen the enforcement efforts of the CFTC and NFA. Specifically, we support the CFTC's proposal to eliminate the automatic stay provision currently applicable to NFA disciplinary actions.

One of the most efficient and effective disciplinary tools employed by NFA has been the member responsibility action, or MRA. The MRA is a summary procedure which, in our experience, has been effective in obtaining prompt compliance with NFA rules and providing protection of customers.

However, section 17(h) of the Commodity Exchange Act currently permits the respondent in an MRA action to secure an automatic stay of the action merely by filing an application for review with the CFTC. We support the CFTC's proposal to place appeals of an NFA disciplinary proceeding on an equal footing with appeals of exchange-imposed sanctions where a stay can be granted by the CFTC, but it is not a matter of statutory entitlement.

In addition, we support the CFTC's proposal to make explicit that the proscriptions against fraud and other abusive practices in section 4(b) of the act apply to marketing of illegal off-exchange futures contracts. We agree that the purveyors of off-exchange futures contracts should not be able to defend fraudulent conduct on the basis of narrow reading of section 4(b).

One last comment I would like to make: I listened with interest to Gary Seevers' remarks in connection with hedging. NAFTA supports the view that it would serve the industry and the public well if this hedging definition were reexplored.

There are a number of areas where anomalies have developed with current industry practice. I think that Gary Seevers set it forth well and I think that all would be served by having the hedging definition looked at under current conditions.

I thank the committee for your attention and thank you for your interest in these matters, and would be willing to answer any questions that you might have.

Senator LUGAR. Thank you. Mr. Feigin.

STATEMENT OF PHILIP A. FEIGIN, ASSISTANT SECURITIES COMMISSIONER, COLORADO DIVISION OF SECURITIES AND CHAIRMAN, COMMODITIES COMMITTEE, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Mr. FEIGIN. Thank you. My name is Philip Feigin. I am the Assistant Securities Commissioner for the Colorado Division of Securities and serve as the chairman of the Commodities Committee of the North American Securities Administrators Association, NASAA. Thank you for inviting us here today.

I prepared and submitted a written statement which I hope will be noted and included in the record.[1]

Senator LUGAR. It will be made a part of the record.

Mr. FEIGIN. Thank you.

I come before you today from a different perspective than most of the witnesses you have heard. I have no real training or familiarity with formal commodities markets, but have spent the last 7 years dealing with tantalum and titanium futures, modern alchemists who turn gold and cash into wood and whose generally accepted accounting principles are usually first-in/gone and single-exit bookkeeping. [Laughter.]

The States, their respective securities and law enforcement agencies have played and will continue to play an important role in the investigation and prosecution of commodities-theme fraud in cooperation with Federal agencies and self-regulatory organizations.

As you are well aware, in past reauthorization hearings NASAA representatives came before this committee considering "CFTC" to be a four-letter word. I am now pleased to report to you that this is no longer the case.

Through the outstanding efforts of the Commission in general, and particularly Chairman Phillips, Commissioner Fowler West, the staff of the Enforcement Division and the general counsel's office, the CFTC has forged a strong and effective union with the States in the battle against off-exchange commodities-theme fraud. I hasten to add that the National Futures Association has been an equal partner in this difficult effort.

This new era of cooperation was aided greatly by amendments to the Commodity Exchange Act enacted in 1982. By enabling the Commission to share information with the States and by adopting the so-called open-season provision, the States were able to assertively assume their proper role in the protection of investors.

The CFTC and NFA have sponsored numerous training seminars for State regulators and law enforcement officials. They have provided expert analysts to assist in investigations and expert witnesses in adversary proceedings, both administrative, civil and criminal; numerous actions have been brought, jointly by the Commission and various States, under section 6d of the act; and, finally, the CFTC, NFA and NASAA have combined to draft the Model State Commodity Code, which is now available to the States for adoption so that they may take full advantage of section 12(e).

Prior to the promulgation of the model code by NASAA in 1985, New York and Florida had adopted similar legislation to combat boilerrooms. Missouri and New Mexico have already enacted the code and it is currently before the legislatures of four other States in one form or another with another four or five jurisdictions actively considering its introduction.

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[1] See p. 323 for the prepared statement of Mr. Feigin.

The States have also been extremely active in the pursuit of boilerroom con artists on their own under existing laws. These criminals of the early 1980's have ripped off billions of dollars across the country from boilerrooms located in New York, Boston, and Fort Lauderdale. Their activities in those areas have been effectively curtailed.

However, an enormous and growing problem still remains. Unfortunately, Senator Melcher, as you observed, like cattle, unwary investors are being led to slaughter constantly, unfortunately at $10,000 or $20,000 a head.

It is estimated that there are at least 100 active boilerrooms located in southern California alone selling precious metals, strategic metals and other arcane and ridiculous investments. This is costing the public billions of dollars a year.

Local prosecutors and investigators are hesitant to proceed because of the interstate if not international scope of the investigations necessary. They are familiar with traditional prosecutions, like rape, burglary and murder, but not the complex paper cases which take up to 6 months to try and perhaps longer.

Federal regulators are strapped for resources and attempt to get the States to assert a greater role. The only really acceptable answer is a Federal mandate to the Department of Justice, U.S. Attorneys, the CFTC and the States to join forces more effectively to do whatever is necessary to thwart the growth of this most dangerous form of economic organized crime.

I would encourage the members of the committee, if you have not already done so, to read the transcript of the Senate's Permanent Subcommittee on Investigations, dated March 19 and March 21, 1984, for a dramatic and terrifying description of the state of commodity investment fraud today and the frustrations connected with its prosecution.

I would also, at this point, like to interject that I believe that the CFTC should be reauthorized for the 6-year period asked. I guess if it works for Senators, it should work for the Commission.

Finally, a word about leverage. NASAA is already on record as firmly opposed to leverage contracts and I reassert that position. In my 7 years experience, aside from the boilerroom problems, the most complaints we have received have been regarding these three or four leverage firms, of which now I believe two exist.

We support the CFTC's proposal assuming that these leverage contracts, of course, will be considered futures contracts. I think as a way of considering them, if we suppose for a moment that leverage contracts had never developed, suppose a firm were to come before this committee today and propose an amendment to the Commodity Exchange Act which would allow the creation of a radically new instrument—an off-exchange futures contract—wherein the firm would take one side of the contract and the customer the other.

We believe it quite unlikely that such a proposal would be accepted. It is a significant problem, but the longer they are perpetuated the harder it will be to correct the mistake that we believe was made 12 years ago.

I thank you and am willing to answer any questions you might have.

Senator LUGAR. Thank you, Mr. Feigin.

Senator Melcher, do you have questions of the witnesses?

Senator MELCHER. Thank you, Mr. Chairman.

Mr. Feigin, are you telling us that the definition of leverage contracts should be such that it would have to be done as futures contracts under the authority of the CFTC and then on the basis of exchanges?

Mr. FEIGIN. Yes. Well, we agree with the staff of the Commission and, I think, have always asserted that leverage contracts were merely futures contracts cloaked under a different heading to basically serve a special interest.

Senator MELCHER. It would have to come under the umbrella of exchanges, then.

Mr. FEIGIN. We would support that concept, yes.

Senator MELCHER. Is that what CFTC is asking for in this legislation?

Mr. FEIGIN. I think that is the implication. They have already held that the instruments are futures contracts at 9 years and 364 days. I think the inference can be drawn that if leverage reference was removed from the act they would be treated as futures contracts like any other if they were allowed to proceed.

I think, also, you have to read into that that they would actually have to be reviewed like any other proposed contract to determine if there was an economic rationale for them to be traded.

Senator MELCHER. Then that would bring them into an exchange?

Mr. FEIGIN. If that determination were made, that is my understanding.

Senator MELCHER. And that is what you support.

Mr. FEIGIN. Yes, sir.

Senator MELCHER. Now, as to the so-called boilerroom operation, what should we do there?

Mr. FEIGIN. Well, it is basically theft by mouth, but I think they are generally called boilerroom operations. It is a very complicated problem. It is very costly to pursue them and I think that is why they persist.

But I believe that the most effective answer is an enhanced effort to prosecute it.

Senator MELCHER. By whom?

Mr. FEIGIN. I think it has to be a combination of the Federal Government and the State and local authorities working together. It cannot be delegated to any one sector.

Senator MELCHER. What would be the language, then, in the bill or the reauthorization act?

Mr. FEIGIN. I don't think the reauthorization bill would change. I think it is a matter of staffing and I think it is a matter of devotion of prosecutorial efforts to the area probably generated in the Department of Justice.

I should mention that, at this point, a task force has been initiated in southern California composed of State, local, and Federal authorities to try and cope with the problem. It has, as yet, had no real success. I think a greater devotion of resources might be necessary.

Senator MELCHER. Were you here yesterday?

Mr. FEIGIN. I was for the latter part of the hearing.

Senator MELCHER. I thought the concern of CFTC indicated that they thought the States ought to handle this.

Mr. FEIGIN. Well, we are trying; but I don't believe that any single authority can do it. Allow me to describe the way these things are set up.

A good example was National Coal Exchange several years ago. They were selling coal from Tennessee; they had their bank account in Kentucky; their sales effort was in Connecticut; and the principals lived in Mississippi.

It is very difficult for any single State, with its limited subpoena power, its authority to investigate and its limited resources, to pursue a case like that.

Senator MELCHER. I may have misunderstood the Chairman of the CFTC yesterday. I would like the staff of CFTC to advise me what the position of CFTC is on this matter.

Senator LUGAR. Could someone enlighten us?

Mr. RAISLER. Certainly, Mr. Chairman.

Senator LUGAR. Would you identify yourself?

Mr. RAISLER. Kenneth Raisler. I am the general counsel of the CFTC.

As regards the Commission's position on leverage, our position is essentially as Mr. Feigin stated it: That by deleting from the act section 19, the effect of that would be that leverage would be considered futures contracts. Therefore, it could only be permitted to be traded as other futures contracts in the exchange environment.

As regards the off-exchange sale of futures contracts, the Commission remains committed to dealing with that to the extent its resources permit it to do so and its priorities permit it to do so. It has engaged in a very aggressive cooperative effort with the Department of Justice, the postal inspectors, the FBI, and the State and local authorities to root out that fraud wherever it is found.

However, it should be recognized that CFTC's resources in this area cannot have it, alone, taking on this obligation. So we have, as Congress did in 1982, looked to expand the participants in this law enforcement effort and brought in all the resources that we can.

We would hope to continue in that effort.

As regards reauthorization with respect to the boilerroom operations, we don't seek any change in the act. We believe the course we have set has been a good one. It has been successful in some sectors of the country.

Southern California does continue to be a problem and we continue to work on it. Hopefully, with the cooperative effort and the devotion and dedication of all of the parties that I mentioned, we will be successful in that regard.

Senator MELCHER. Thank you very much.

Thank you, Mr. Feigin.

Senator LUGAR. It seems to me Ms. Phillips did, however, get into States' enforcement under certain conditions. My recollection, I think, is the same as his: That we had not mentioned the States coming into this.

Is the case in which the States become involved one in which these efforts of leverage will remain off-exchange, not qualify, and therefore be in some limbo and, therefore, the CFTC does not deal with it?

I am confused a little bit, too, as to what the Chairman was consigning to the States at this point.

Mr. RAISLER. Let me attempt to clarify that, Mr. Chairman.

The Commission's proposal would require that leverage be traded on exchanges. If that is done, the leverage firms continued sale of leverage contracts without doing it in the exchange environment would be unlawful.

Senator LUGAR. Yes.

Mr. RAISLER. It would be an unlawful futures contract which would be subject to the jurisdiction of the CFTC, Justice Department, and the States.

The Chairman specifically did reference, however, that in accordance with the development of the model code the businesses of the leverage firms could change and instead of being a futures contract could instead go to what was described as a cash-and-carry contract or an installment contract.

Both of those contracts are perhaps typical of any coin-shop type of operation or a local purveyor of metal, or even a more national purveyor of metal in the nature of Deak-Perera or some company like that that is locally known, and that operation would not be considered, if it met the constraints of the model code or State legislative initiatives, and CFTC interpretation, to be selling futures contracts.

It, therefore, would not be subject to CFTC jurisdiction and those operations would be locally regulated to the extent that there is any regulation at all. So there is that distinction.

If they do change their business operations, they would by that means come outside.

The problem that we have seen in the past and the one that Mr. Feigin alluded to was an off-exchange futures sale, and that continues to be a concern of the CFTC. But if it is not determined to be a futures contract, but is instead an installment or a cash transaction, it is outside of our jurisdiction; therefore, would fall under more likely the local jurisdiction, local authority.

Senator LUGAR. Are there just two firms left in the leverage business?

Mr. RAISLER. There are two firms that the Commission has registered and a third firm whose application is pending at the present time. That is the entire universe of firms that have asked for qualification under the Commission's grandfather provision.

Senator LUGAR. So if any one of these two or three firms change their business, then they might fall under this enforcement of the State only as a coin shop or something like that.

Mr. RAISLER. That is correct, If they did not seek any kind of an exchange alternative, but continued to do business under a different means—by installment or cash-and carry sale—they would be outside.

Senator LUGAR. There are not more than two or three States that would be involved in it. Do they have branches?

Mr. RAISLER. Well, I think there would be two aspects of that—and perhaps Mr. Feigin could comment on this as well—that most of them have a central office, but to the extent that they sell in other States they would be subject to those States' authorities, including lending authorities as well as other kinds of regulatory controls.

The model code was, in fact, intended to basically be an anti-bucket shop or anti-boiler-room statute, but it expressly understood or recognized that certain kinds of activity that is ongoing today—legitimate cash sale business—should be able to continue under State authority.

Senator LUGAR. Mr. Feigin, you have testified that in the event that we were to take history back 12 years and take a look at the leverage situation, we might not have made the same decision; but, of course, the decision was made 12 years ago and we are now at this point with two firms and one application involved.

What is your suggestion at this point in time? Clearly it is a dilemma that has faced this committee—at each of the last two authorizations I remember it was a major issue—and essentially the 1982 solution is the one we are now operating under in which the efforts to expand this industry leverage have been stopped; but those who are there can grandfather.

One firm, I recall, has gone out of business in this interim period.

What should our course of action be in this reauthorization?

Mr. FEIGIN. Well, it truly stands like a Hobson's choice. I believe that the continued existence of the two companies doing business as they do might be unjustifiable as anticompetitive. If they can do it, why should other companies not be allowed to?

Yet their business defies the principles of the Commodity Exchange Act. It is highly unlikely that these things can be traded on exchanges.

I believe and hope that there is a mechanism by which they can either sell their contracts on exchanges or alter their form of business so that they conform better with the model code. I might specify three different ways in which they could sell these contracts or contracts like them under the model State commodity code.

Granted, it is not really State law yet very extensively, but we have hopes that it will be.

They could engage in a business that would otherwise require them to be registered as futures commission merchants or securities broker/dealers and, therefore, obtain an exemption from the ban on contracts such as theirs; or the code at least provides for a new category of persons called a commodity broker/dealer, which would be a State-licensed entity and new forms of regulation would have to be developed to audit them and inspect them under State restrictions.

So there are a couple of alternatives. I agree that it is not particularly easy, but I guess the comment I am making is that it will get progressively worse as the thing perpetuates under the system now in place.

Senator LUGAR. But the CFTC has at least offered a method of progress in the report that Ms. Phillips made yesterday, as I recall: in other words, that you either get into the exchange situation or you get into a different form of business.

Mr. FEIGIN. I would agree with that. Although I am certainly not an expert in the area, I don't see that the exchange alternative is particularly workable.

I think that the method of sale may have to be altered, the method of the contract would have to be altered, and that might be a more reasonable approach.

Senator LUGAR. Senator Melcher, do you have further questions of these witnesses?

Senator MELCHER. No; and I thank you very much.

Senator LUGAR. Thank you very much.

Our final witness today will be Gregory C. Glynn, attorney, of Glynn & Graham, Washington, DC, accompanied by John F. Walter, of Los Angeles, CA.

We welcome you to the hearing. Would you please proceed.

STATEMENT OF GREGORY C. GLYNN, ACCOMPANIED BY JOHN F. WALTER, LOS ANGELES, CA

Mr. GLYNN. Mr. Chairman, members of the committee. My name is Gregory Glynn. John F. Walter, of Los Angeles, is on my left. My comments will suffice for both of us.[1]

It is my privilege to appear here today before you in connection with the hearings on the 1986 reauthorization of the Commodity Futures Trading Commission. During the period 1979 through early 1983, it was my good fortune to serve as associate general counsel for litigation for the CFTC; and, I might say, immediately prior to that I was assistant chief trial attorney at the Securities and Exchange Commission for 4 years.

I am presently engaged in the private practice of law in Washington, DC, and am chairman of the international commodity regulation committee of the international law section of the American Bar Association. I might note that my comments are not those of the ABA, but those solely of myself as an individual.

I come here before you today because of my concern as an attorney and erstwhile teacher of constitutional law about certain amendments proposed by the CFTC to sections 17 (h) and (i) of the Commodities Exchange Act. My comments are limited to those proposals.

In this reauthorization package, the CFTC recommends abolishment of the automatic State provisions and mandatory requirement for oral argument currently contained in section 17(h) of the act. As you know, sections 17 (h) and (i) deal with Commission review of disciplinary actions taken against members by the National Futures Association, or NFA.

Our firm has, from time to time, represented before the CFTC and in Federal courts various individuals and firms engaged in the commodities business both as plaintiffs and defendants. Together with Mr. Walter, of Los Angeles, we have represented an individual who was twice sanctioned by a summary procedure known as a member responsibility action, or MRA, by the National Futures Association.

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[1] See p. 326 for the prepared statement of Mr. Glynn and p. 335 for the prepared statement of Mr. Walter.

The propriety of those sanctions is currently on appeal to the Commission and I will not address the specifics of that.

My particular and instant concern arises from the language contained in sections 301 and 302 of the bill—S. 2045—which proposes to amend sections 17 (h) and (i) of the Commodity Exchange Act to delete the automatic stay provisions and right to oral argument set forth in the current versions of sections 17 (h) and (i) of the act.

The basis of our concern is simply that the automatic stay and oral argument provisions of the current sections 17 (h) and (i) provide a safety valve and check on the use by the National Futures Association of a summary proceeding known as the MRA.

The NFA proceeding, known as the MRA, allows the NFA to take a summary and ex parte action against a member without a prior hearing. Such action could not be taken by the CFTC, itself, or indeed by any Government agency. Membership in the NFA is, as a practical matter, compulsory and not voluntary since section 17(m) of the act provides that the CFTC may allow the NFA to impose compulsory membership on the industry; and, indeed, NFA by its bylaw 1101 prohibits any of its members from trading in any way with nonmembers of the NFA.

I might add that absent express statutory authorization and imprimatur by the Congress, such a trading prohibition would appear to violate the antitrust laws as an unlawful restraint of trade in violation of section 1 of the Sherman Act.

The very essence of the Government's dealing with all of its citizens is that fundamental fairness be observed at all times. As you know, the fifth amendment to the Constitution provides that no person shall be deprived of life, liberty, or property without due process of law.

A U.S. district court may grant a temporary restraining order, or TRO, only pursuant to the provisions of rule 65 of the Federal Rules of Civil Procedure. That rule requires proof of immediate and irreparable injury, and an attorney's certificate as to why notice to the opposing side cannot or should not be given in order for the TRO to issue.

A TRO expires at the end of 10 days and may be extended or rolled over for only one additional 10-day period. In the event of an ex parte TRO, a preliminary injunction must be set down for a hearing by the district court at the earliest possible time.

The imperative of prompt and fair review of injunctions has led to the doctrine that orders of Federal courts granting, continuing, modifying, refusing, or dissolving injunctions are appealable of right as interlocutory orders under 28 United States Code, section 1292(a), notwithstanding the general rule that only final decisions of the district courts are appealable under section 1291 of the Judiciary Code.

The Congress has generally denied the right to seek ex parte restraining orders or injunctive relief to the CFTC itself under section 6c of the act. The only case where a Federal court may issue an ex parte restraining order to the CFTC is to prohibit any person from destroying, altering, disposing of, or refusing to permit authorized representatives of the Commission to inspect, when and as requested, any books and records, or other documents, or which prohibits any person from withdrawing, transferring, removing, dissipating, or disposing of funds, assets, or other property—basically, the destruction of records.

Moreover, the Commodities Exchange Act provides that the CFTC may use its administrative procedures to prohibit a person from trading, or to suspend or revoke his registration only—and I emphasize only—upon the issuance and serving of a complaint upon that person and a hearing which may be held not less than 3 days after service of the complaint. That is in section 6(b) of the act.

Indeed, the CFTC is required to grant a hearing to any person whom it proposes to refuse to register under section 8(a)(3) of the act unless that person is already subject to an existing statutory disqualification which has resulted from a previous hearing under section 8(a)(2) of the act.

The import of the foregoing analysis is simply that the CFTC could not do to an individual registrant what the NFA has done utilizing the summary MRA proceeding. The CFTC, as a governmental agency, is limited by its enabling statute, the Commodities Exchange Act, and by constitutional due process.

Ironically, the NFA takes the position that it has no due process limitations because of its status as a private organization; but we submit that by requiring compulsory membership in the NFA under section 17(m) of the act and allowing NFA's rule 1101, which bars all NFA members from dealing with nonmembers, the CFTC has in effect deputized the NFA; delegated clearly governmental functions, such as registration and discipline, to it; and conferred a quasi-governmental status upon it.

Because of the foregoing, we believe that the NFA ought to observe the principles of fundamental fairness. The very essence of due process is, in the words of Mr. Justice Frankfurter: "The right to be heard before being condemned to suffer grievous loss of any kind," taken from *Joint Anti-Fascist Refugee Committee* v. *McGrath*, a 1951 decision of the Supreme Court.

Indeed, the arbitrary and secret procedures utilized by the NFA in issuing the two MRA's ex parte without prior notice and hearing echo the actions of the executive branch in designating, without notice or hearing, certain charitable organizations as Communist to the Loyalty Review Board which, in turn, disseminated the information to all Federal departments and agencies.

In the *Joint Anti-Fascist Refugee Committee* case, the Supreme Court condemned such actions and found that such conduct stated a cause of action for defamation.

The automatic stay provisions and prompt Commission review currently contained in section 17(h) of the act are a last bastion or protection for a Commission registrant and compelled NFA member from the arbitrary and secret ex parte expulsion decisions of the NFA under the MRA provisions of NFA compliance rule 3-12.

What the NFA has done here the Commission, itself, could not do under section 17(l)(2) of the act to an NFA member, nor could the Commission take such actions ex parte and without prior hearing under sections 8(a) (1) through (4) of the act.

Indeed, we submit that NFA compliance rule 3-12 is contrary to the rule requirement for a fair and orderly procedure with respect to the disciplining of members set forth in 17(b)(9) of the act. Nor is the MRA used solely by the NFA for true emergency situations.

While market emergencies may properly be amenable to consideration and summary treatment under the CFTC's emergency powers contained in section 8(a)(9) of the act or under the emergency rules of designated contract markets or exchanges, garden-variety disciplinary proceedings against members are properly handled with prior hearings fairly conducted before the imposition of sanctions.

In reviewing NFA sanctions, including an MRA, we submit that the CFTC has an obligation to use a constitutional due process analysis with regard to NFA procedures. Simply put, if the CFTC cannot take certain action because of constitutional due process limitations imposed by the fifth amendment or because of the hearing and fairness limitations imposed by the Commodities Exchange Act, the CFTC cannot allow the NFA to do such at its direction and should not affirm or approve NFA actions which do not meet these CFTC standards.

In view of the stated shortcomings in the NFA hearing procedures, we submit that it is most appropriate to continue the automatic State provisions and provisions for oral argument contained in section 17(h) of the act. The shortcomings of the NFA procedures specified above regarding the MRA prudently suggest that the registrant be protected by the Commission from wholesale and irreversible deprivation of rights, and that the automatic stay protect these rights until a reasoned Commission decision.

A reasoned Commission decision on the propriety of continuing the automatic stay should be capable of being made within 1 week or 10 days. This is the time period generally used by courts of appeals in determining stay questions on appeals from Federal district courts.

Oral argument promotes a reasoned Commission decision on the stay and give the registrant the perception of fairness which is so important to our system of justice.

I would like to close, Mr. Chairman, simply by reading Mr. Justice Frankfurter's words from the *Joint Anti-Fascist Refugee Committee* case:

> Man being what he is cannot safely be trusted with complete immunity from outward responsibility in depriving others of their rights. At least such is the conviction underlying our Bill of Rights.
>
> That a conclusion satisfies one private conscience does not attest its reliability. The validity and moral authority of a conclusion largely depend on the mode by which it was reached.
>
> Secrecy is not congenial to truth-seeking, and self-righteousness gives too slender an assurance of rightness. No better instrument has been devised for arriving at truth than to give a person in jeopardy of serious loss notice of the case against him and opportunity to meet it, nor has a better way been found for generating the feeling so important to a popular Government that justice has been done.

It is, thus, not only important that justice be done and the process be fair, but it also must manifestly appear to be so.

I thank the committee for its attention and I would like to say that I endorse wholeheartedly the proposed 6-year reauthorization of the Commodity Futures Trading Commission.

Senator LUGAR. Thank you very much, Mr. Glynn.

I would ask if you have any further testimony on other issues as you have listened today—you have had experience with the Commission—the definition question for example, do you have any further comments on that?

Mr. GLYNN. No, I do not.

As far as leverage is concerned, I was at the Commission when, in 1979, the Commission, under an opinion of its general counsel's office, proposed simply to treat leverage as futures contract and to ban them, and then in the 1982 legislation they were specifically allowed.

But I have represented plaintiffs in leverage cases and have not represented one of the leverage merchants. I know Premex is in bankruptcy in San Diego.

I suppose I support the Commission's position on that.

Senator LUGAR. Very well.

I think your position on the section 17 issues is clear as you have outlined it in your testimony. We appreciate the careful preparation of the testimony and your appearance this morning.

Mr. GLYNN. Thank you for allowing me to be here, Mr. Chairman.

Senator LUGAR. Thank you.

The hearing is adjourned.

[Whereupon, at 12:19 p.m., the committee adjourned, subject to call of the Chair.]

[Additional material submitted by Senator Lugar:]

Commodity Futures Trading Commission,
Washington D.C., March 13, 1986.

The Honorable Richard G. Lugar
Chairman, Subcommittee on Agricultural Research,
Conservation, Forestry, and General Legislation
Committee on Agriculture, Nutrition, and Forestry
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your kind letter of February 20, regarding the Commission's audit trail rule and capital proposals as well as the time-table for Senate consideration of the Commission's reauthorization bill.

Enclosed for your information is a March 4, 1986 letter from the Chicago Mercantile Exchange and the Chicago Board of Trade regarding their proposed Computerized Trade Reconstruction ("CTR") system and a recent version of the CTR proposal. The Commission agrees with the description in the second paragraph of the exchanges' March 4 letter of the requirements of the Commission's audit trail rule. Based on the exchanges' representations of the time and sequencing accuracy of their trade reconstruction system, their proposal has the capability of meeting the standards of the rule. The Commission stands ready to assist the exchanges as they more fully develop the technical aspects of their proposals. In addition, the system would, of course, be assessed as part of the Commission's regular oversight responsibility.

With respect to capital, in response to a request by the Futures Industry Association, the Commission recently extended the comment period on its capital proposals until April 4. We understand that several industry committees are developing alternative capital proposals. Since any capital rule changes would have to be reproposed for public comment if there are significant changes, as are currently contemplated, this issue also is not likely to be resolved completely in the near term.

The Commission respectfully requests that this letter, the enclosures referred to herein and a chronology of events surrounding the audit trail we have prepared be considered as a report on this issue requested by the Committee at the recent hearings, and that they be insert in the record of my testimony at the appropriate place.

Sincerely,

Susan M. Phillips, Chairman.

Enclosures.

March 4, 1986.

The Honorable Susan M. Phillips
Commissioner, Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Dear Chairman Phillips:

The Chicago Board of Trade and the Chicago Mercantile Exchange appreciate your assistance in arranging for an in-depth presentation on February 27, 1986, of our proposed Computerized Trade Reconstruction ("CTR") system. Attendance by Commissioners Hineman, West, Seale and Davis and CFTC staff underscores the CFTC commitment you stated, to "continue the dialogue which has begun."

We would also like to take this opportunity to clarify our letter of February 25th. Its tone was due to our misinterpretation of Regulation 1.35(g). As we now understand it, the Regulation is not to be read in its narrowest, most-technical sense. Therefore, we are certain that our CTR proposal will effectively meet its standards.

As you probably surmised from the enthusiasm of our presentation, we are convinced the CTR represents the finest audit trail system possible. It relies on sophisticated state-of-the-art computer technology and results in a remarkable surveillance tool for on-line analysis of trade data. Most importantly, CTR does not impair market liquidity nor diminish the speed of execution and confirmation.

In our opinion, the meetings were extremely constructive. We had the opportunity to respond directly to Commissioners' questions regarding CTR, to clear the air and to resolve our previous differences. We trust that the CFTC Commissioners and its staff agree with our view that we are now on a cooperative road to resolution of this issue.

In this spirit, we offer to continue to work with the Commission to achieve the audit trail result we mutually seek. We stand ready to respond to any further queries.

Sincerely,

John Sandner, Chairman, Chicago Mercantile Exchange; Leo Melamed, Special Counsel, Chicago Mercantile Exchange; William J. Brodsky, President & C.E.O., Chicago Mercantile Exchange; John F. Gilmore, Chairman, Chicago Board of Trade; Thomas R. Donovan, President & C.E.O., Chicago Board of Trade.

CHICAGO MERCANTILE EXCHANGE AND CHICAGO BOARD OF TRADE

COMPUTERIZED TRADE RECONSTRUCTION PROPOSAL

Introduction

This submission contains the salient elements of Computerized Trade Reconstruction (CTR), the newly proposed system of the Chicago Board of Trade and the Chicago Mercantile Exchange.

The primary goal of CTR is to provide an accurate, effective audit trail. CTR achieves this result by identifying a computer generated transaction time for every trade.

Our system will provide this effective audit trail and present a deterrent to trading abuses without necessarily identifying times within one minute of execution for every trade under all circumstances. CTR will be more exact in assigning times to some transactions than others. CTR is most effective in assigning times to customer order, the execution of which is perceived as a significant source of problems and potential rule violations.

Additionally, with respect to floor trader transactions, CTR utilizes sequencing of trading cards, in conjunction with trade-time information, to detect intra-day manipulation, speculative limit violations, and other possible trade infractions.

Finally, CTR will be an overall deterrent to trade violations and abuses. CTR either reliably captures the time of the transaction or its position among the trades of a local. The instances when the time is not correctly calculated are few and cannot be anticipated. Because the failures are infrequent and unpredictable, no broker or local can rely on a flaw in the system in order to plan a rule violation.

I. Goals of an Effective Audit Trail

An enhanced audit trail or an enhanced ability to reconstruct trading daily is not a goal in itself. It is simply a means to achieve goals.

Our goals in proposing a computerized system which will aid in the reconstruction of trading in a timely manner are:

A. To enhance our ability to detect trading abuses;
B. To enhance our ability to gather evidence to aid in proving trading abuses;
C. At the same time, to maintain the operational efficiency of the exchanges and their clearing members; and
D. At the same time, to maintain the liquidity necessary for the health and growth of the markets.

II. Elements

The computerized system that we recently proposed to the CFTC contains the following elements:

A. The time at which a customer order is received on the exchange floor will be submitted by clearing members along with the other trade data and will be included in the exchange's data base;
B. A time factor, which will represent the time it takes an order to reach the trading pit, will be calculated for each commodity. This factor will be added to the time in II.A above. The resultant time will represent the approximate time at which an order was received in the trading pit. This time will also be the time at which a search of Time and Sales is begun in order to be able to assign a time to each Type 2 (non-public) and Type 4 (public customer) transaction;
C. A Time and Sales Report which contains the time to the nearest second or ten seconds at which a sales took place or a bid or offer was made;
D. The time of execution for all Type 3 trades will be submitted by clearing members along with other trade data and will be included in the exchange's data base;
E. The number for each member's trading cards, which will be pre-numbered and must be used in order, will be submitted by clearing members along with other trade data and will be included in the exchange's data base;
F. The sequence of each member's trades within a trading card will be required;
G. The intra-day pick-up of each member's trading cards during the trading session;
H. The bracket designation for each trade representing the half-hour in which the trade occurred will continue to be required of brokers and traders and will be submitted by clearing members along with other trade data and will be included in the exchange's data base;
I. Accurate account numbers will be submitted by clearing members along with other trade data and will be included in the exchange's data base; and

J. Edit checks to insure that data is inputted for A, D, E, H, and I.

III. **How the System Works**

A. **Overview.**

Our system will be based on the assumption that, starting with various knowns (time and sales report, time-in on Type 2 and 4 trades, execution times for Type 3 [member for member] trades, unique times within a bracket, who traded with whom, how long it takes for an order to be transmitted from desk to pit, brackets, etc.), we can generate, through the use of computer programs, unknowns, which approximate the time of execution sufficiently to give us an adequate audit trail. After the first four passes, Steps III.B.1 through 4 below, times will be derived for approximately 80 percent of all trades. These times will be excellent approximations of the time of execution and will enhance our ability to reconstruct trading when necessary. The remaining 20 percent of all trades will be between floor traders for their own accounts and will have times associated with them as a result of computer applications designed to effectuate Steps III.B.5 through 7 below. These times will be sufficiently accurate to produce an adequate audit trail. In addition, we will be able to sequence completely the trades of a floor trader because of the requirements that pre-numbered cards be used in sequence and that trades be entered in sequence on a card and because we will have times associated with these trades.

B. **The following steps describe our system.** Each step represents a "pass" that the computer must make over known data before assigning times to transactions. In addition, the computer will make multiple passes during Steps 5 and 6, during which time it will generate times and assign them to trades. These times along with other data will be evaluated and new times will be generated and assigned. The program will continue to run in this loop until no new times can be generated.

A more detailed explanation of these passes follows:

1. Unique Price Time Identification. Within each half-hour bracket (9:00 to 9:30, for example), sales at unique prices will occur. These unique prices, which will be contained in the system, will have a time associated with them. And, these times will be matched by the computer to all those trades occurring in that same bracket at that same price.
2. Type 3 Trade Time Identification. CFTC Regulations currently require that members, who while on the exchange floor receive an order from other members on the exchange floor, write down the time at which the order was executed. These times will be inputted by clearing members and will be assigned to Type 3 trades and to all trades opposite these Type 3 trades.
3. Types 2 and 4 Trade Time Identification. The time at which all public orders (Type 4 trades) and non-public orders (Type 2 trades) are received on the floor will be inputted by clearing members and maintained in our data base. This time plus a commodity time factor will closely approximate the time at which an order was received in the trading pit. This adjusted time, which will also be in the data base, will be the time at which the computer will begin to search the Time and Sales Report looking for a price and is the same as the price at which the order was filled. Once

this price is found, the computer will assign the time associated with that price to the order. These times will be available for daily review and analysis by the Exchange Compliance Department.

Preliminary analysis shows that Type 2, 3 or 4 trades represent one side of a transaction approximately 79 percent of the time.

4. Identification of Times to Trades Opposite Types 2, 3 and 4 Trades. The derived times for Types 2, 3 and 4 trades, which will be highly accurate, will be assigned to the other side of those trades by the computer. This will result in times for these trades, which are also excellent.

   As a result of Steps 1 through 4, approximately 79 percent of all trades will have very accurate times assigned to them.

5. Identification of Floor Trader Times (Part 1). After Step 4, times for trades by a floor trader will have been derived when the trade was made at a unique price (Step 1) or when the trade was opposite a Type 3 trade (Step 2) or Type 2 or 4 trade (Step 4). Some Type 1 trades, however will still not have a price derived for and assigned to them. This Step will reduce that number further by reviewing those trades that have assigned times and by taking into consideration the sequence of the local's trades. In addition, the computer will analyze the opposition side of a floor trader's trades searching for a time or times that were derived in Steps 1 through 4 above. The search is intended to assign the narrowest time window to the trade and then, within that time window, ascertain if the local's trade price is unique. If it is, that time will then be assigned to the local's trade. If none is found, then Step 6 will be used.
6. Identification of Floor Trader Times (Part 2). After Step 5, for those trades still not identified with respect to time, the computer will further identify times for floor traders by comparing their time/price sequence to "Time and Sales" time/price sequence.
7. Identification of Floor Trader Times (Part 3). After Step 6, the computer will utilize the bracket information and opposite trader or broker information and assign the "best" time to any remaining unknown trades.

IV. **What Does This Give Us**

A. **Public and Certain Other Order Orders (Types 2, 3 and 4 Trades).** First of all, public orders will have very accurate times associated with them respecting when they are received on the floor. Using these times, the computer will derive very accurate times, which will approximate the times of execution and will be assigned to these trades. An analysis of these times will allow an exchange to reconstruct daily, with a high degree of accuracy, the order of execution of public orders. This also would apply to Types 2 and 3 trades that will also have highly accurate times associated with them.

B. **Trades Opposite Public and Certain Other Orders.** Second, trades, including trades for floor traders, opposite customer orders will have time assigned to them by the computer. As a result the computer application for Steps 1 through 4, Part

III.B above, approximately 75 percent of all members' trades will have a time assigned to them.

C. **Floor Trader-to-Floor Trader Trades.** Third, the remaining 25 percent of the members' trades, which represent approximately 20 percent of total exchange trades, will have times assigned to them in Steps 5 through 7. Although we believe that our computer applications will derive accurate times for these remaining trades, we cannot estimate the accuracy of these times presently. It is important to note, however, that for these floor trader-to-floor trader trades, we will be able to reconstruct the sequence of their trading cards by computer. And, if more detail is necessary or desirable, we can request a member's trading cards to determine the exact sequence of these trades. This will be possible because of the proposed requirement that members use pre-numbered trading cards and that they enter their trades in sequence on a trading card.

V. How Does This Compare to the CFTC's Requirement

A. **Impact on Market Liquidity.** The CFTC's system would have a dramatic impact on market liquidity by requiring brokers and floor traders to take time out from filling customer orders or trading, respectively, in order to ascertain the current time and then mark this time down on the orders or trading cards. Our system does not rely on requiring brokers or floor traders to mark the time and, accordingly, will have no impact on market liquidity.

B. **Impact on Operational Efficiency.** Unfortunately, in order to get times into an exchange's data base, the member firms and the exchanges will have to change their systems, while incurring initial and ongoing costs. In addition, because of ongoing requirements to input and analyze data, both groups will be adversely affected operationally. We will, of course, continue to study ways of reducing this impact; however, we know of no ways of eliminating this effect presently.

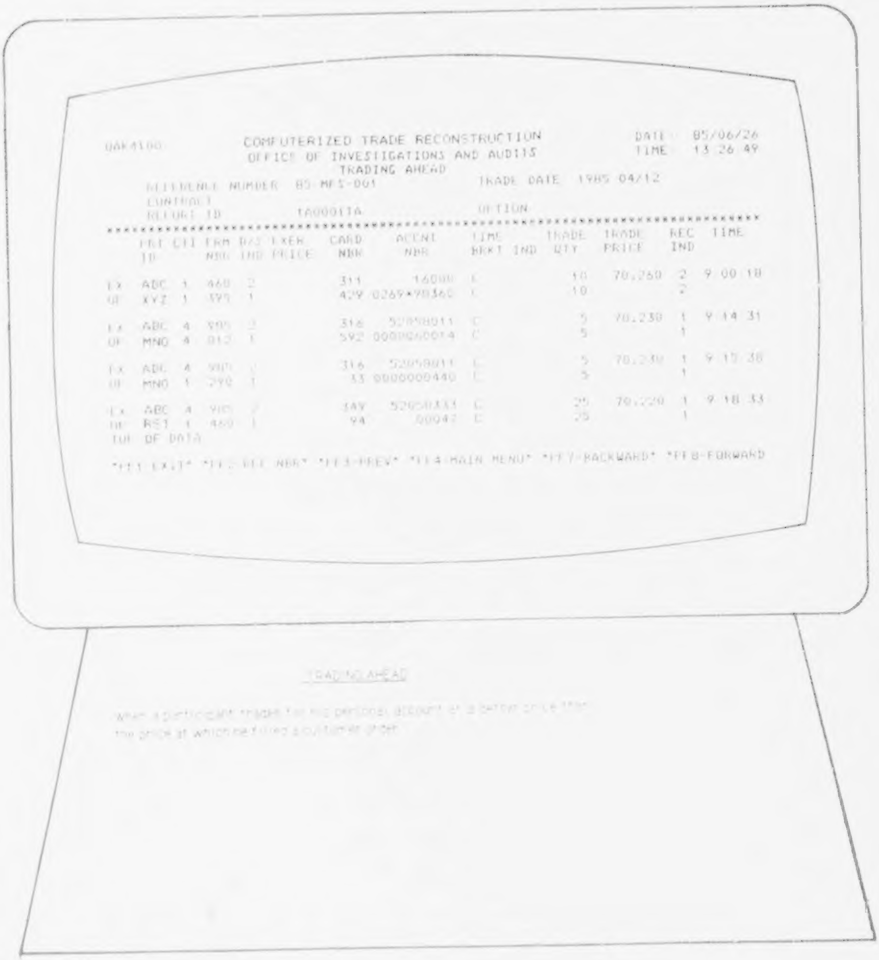
C. **Impacts on Confirmations to Customers.** The CFTC requirement that brokers accurately record times will force them to protect themselves by checking with the opposite party and checking against the Time and Sales record. Checking will take place when a market hiatus occurs. This will delay the return of orders to the desk and confirmation to customers. Delayed confirmation affects the customer's ability to make rapid, correct business decisions. The exchange's system will not have this effect.

D. **Impact on Executions.** The CFTC system will force brokers to determine the time of their last trade, check that time with the opposite party and enter that time on the order ticket. Delayed execution results in inferior fills or the inability to enter a market at critical time for placing a hedge. The exchanges' system will not have this impact.

E. **Impact on Compliance Program.** First, the accuracy of the exchanges' system will not be as dependent on the precision of information supplied by brokers and locals, whose conduct is subject to continual exchange review. As a result, our system will have a deterrent effect on a broker or local since times derived for their trades will be largely independent of the information they provide us.

Second, our system will aid in the detection of intra-day speculative limit violations and intra-day manipulations, violations with which the CFTC has been particularly vocal. In addition, the detection of other time-sensitive violations will also be enhanced.

Third, tne new timing information will become an integral part of the exchange's overall compliance program.



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OAK4100          COMPUTERIZED TRADE RECONSTRUCTION             DATE  85/06/26
                 OFFICE OF INVESTIGATIONS AND AUDITS           TIME  13:26:49
                           TRADING AHEAD
    REFERENCE NUMBER  85-MFS-001               TRADE DATE  1985 04/12
    CONTRACT
    REPORT ID          TA00011A                OPTION
*****************************************************************************
    MKT CTI FRM B/S EXER   CARD     ACCNT     TIME       TRADE  TRADE   REC  TIME
    ID      NBR IND PRICE  NBR      NBR       BRKT IND   QTY    PRICE   IND

EX  ABC  1  460  2         311       16000  C               10  70.260  2  9:00:18
OF  XYZ  1  395  1         429 0269*98360  C               10          2

EX  ABC  4  905  2         316   52858011  C                5  70.230  1  9:14:31
OF  MNO  4  012  1         592 0000060014  C                5          1

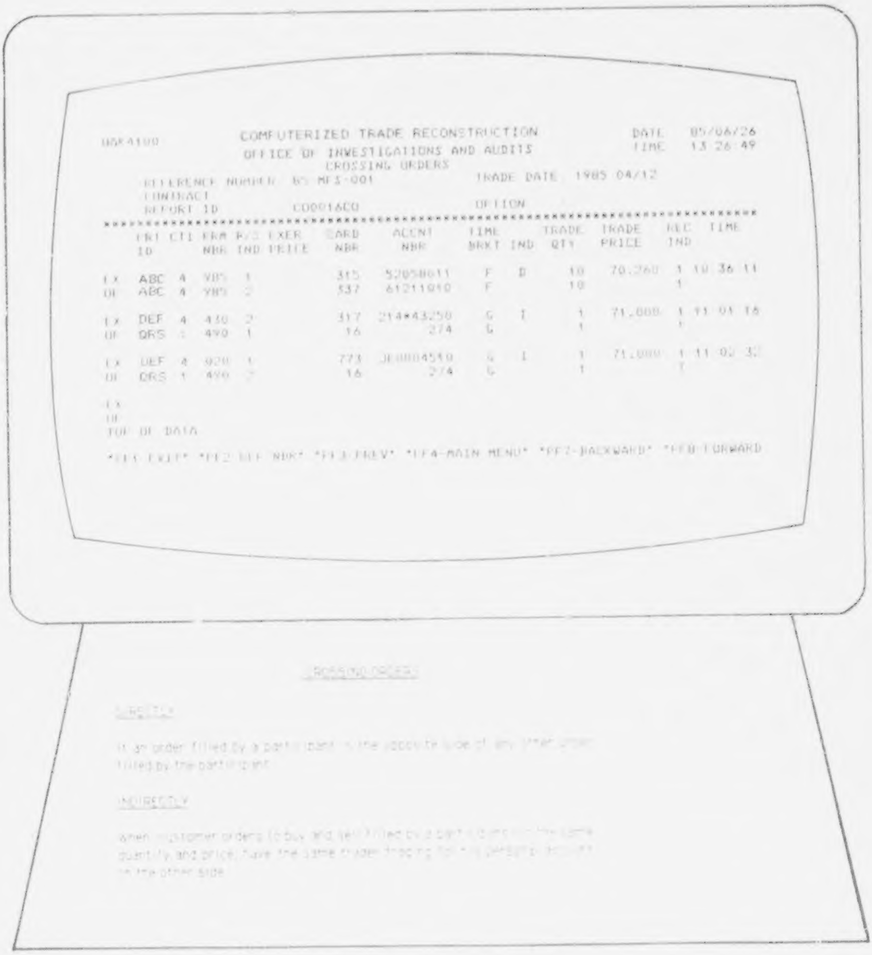
EX  ABC  4  905  2         316   52858011  C                5  70.230  1  9:15:38
OF  MNO  1  290  1          33 0000000440  C                5          1

EX  ABC  4  905  2         3AY   52858333  C               25  70.220  1  9:18:33
OF  RST  1  460  1          94      00047  C               25          1
TOP OF DATA

*PF1-EXIT* *PF2-REF NBR* *PF3-PREV* *PF4-MAIN MENU* *PF7-BACKWARD* *PF8-FORWARD
```

TRADING AHEAD

When a participant trades for his personal account at a better price than the price at which he filled a customer order.



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OSK4100          COMPUTERIZED TRADE RECONSTRUCTION           DATE  85/06/26
                 OFFICE OF INVESTIGATIONS AND AUDITS         TIME  13:26:49
                          CROSSING ORDERS
    REFERENCE NUMBER  85-MFS-001             TRADE DATE  1985 04/12
    CONTRACT
    REPORT ID         C0001AC0               OPTION
*******************************************************************************
    FRT CTI FRM B/S EXER   CARD    ACCNT     TIME      TRADE  TRADE   REC  TIME
    ID      NBR IND PRICE  NBR     NBR      BRKT IND   QTY   PRICE   IND

EX  ABC  4  YB5  1          315   52058611   F    D      10   70.260  1 10 36 11
OF  ABC  4  YB5  2          337   61211010   F           10           1

EX  DEF  4  430  2          317  214*43250   G    I       1   71.000  1 11 01 16
OF  QRS  1  490  1           16        274   G            1           1

EX  DEF  4  920  1          773  JE0004510   G    I       1   71.000  1 11 02 32
OF  QRS  1  490  2           16        274   G            1           1

EX
OF
TOP OF DATA

*PF1-EXIT* *PF2-REF NBR* *PF3-PREV* *PF4-MAIN MENU* *PF7-BACKWARD* *PF8-FORWARD
```

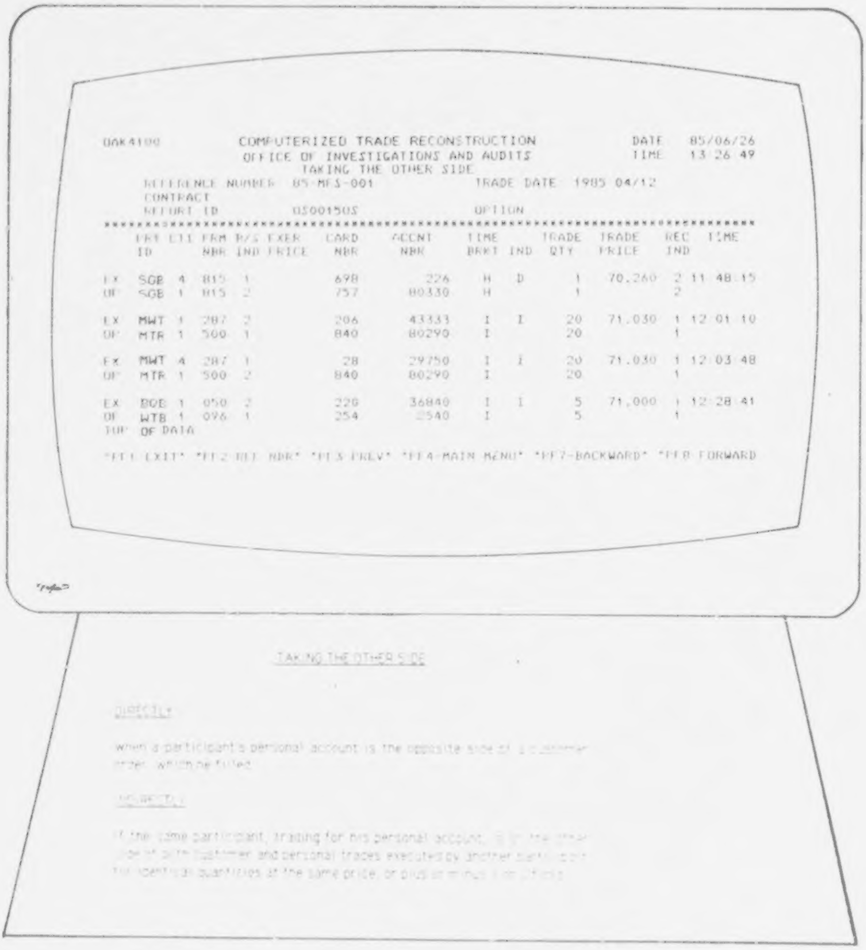
CROSSING ORDERS

DIRECTLY

Is an order filled by a participant on the opposite side of any other order filled by the participant.

INDIRECTLY

When customer orders to buy and sell filled by a participant for the same quantity and price, have the same trader trading for his personal account on the other side.



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OAK4100          COMPUTERIZED TRADE RECONSTRUCTION            DATE  85/06/26
                 OFFICE OF INVESTIGATIONS AND AUDITS          TIME  13 26 49
                        TAKING THE OTHER SIDE
    REFERENCE NUMBER  85-MFS-001              TRADE DATE  1985 04/12
    CONTRACT
    REPORT ID          0S00150S               OPTION
****************************************************************************
    PRT CTI FRM B/S EXER   CARD     ACCNT     TIME       TRADE  TRADE   REC  TIME
    ID      NBR IND PRICE  NBR      NBR       BRKT IND  QTY    PRICE   IND

EX  SGB 4  815  1          698        226      H    D      1   70.260  2 11 48 15
OP  SGB 1  815  2          757      80330      H           1           2

EX  MWT 1  287  2          206      43333      I    I     20   71.030  1 12 01 10
OP  MTR 1  500  1          840      80290      I          20           1

EX  MWT 4  287  1           28      29750      I    I     20   71.030  1 12 03 48
OP  MTR 1  500  2          840      80290      I          20           1

EX  BOB 1  050  2          220      36840      I    I      5   71,000  1 12 28 41
OP  WTB 1  096  1          254       2540      I           5           1
TOP OF DATA

*PF1 EXIT* *PF2 REF NBR* *PF3 PREV* *PF4-MAIN MENU* *PF7-BACKWARD* *PF8 FORWARD
```

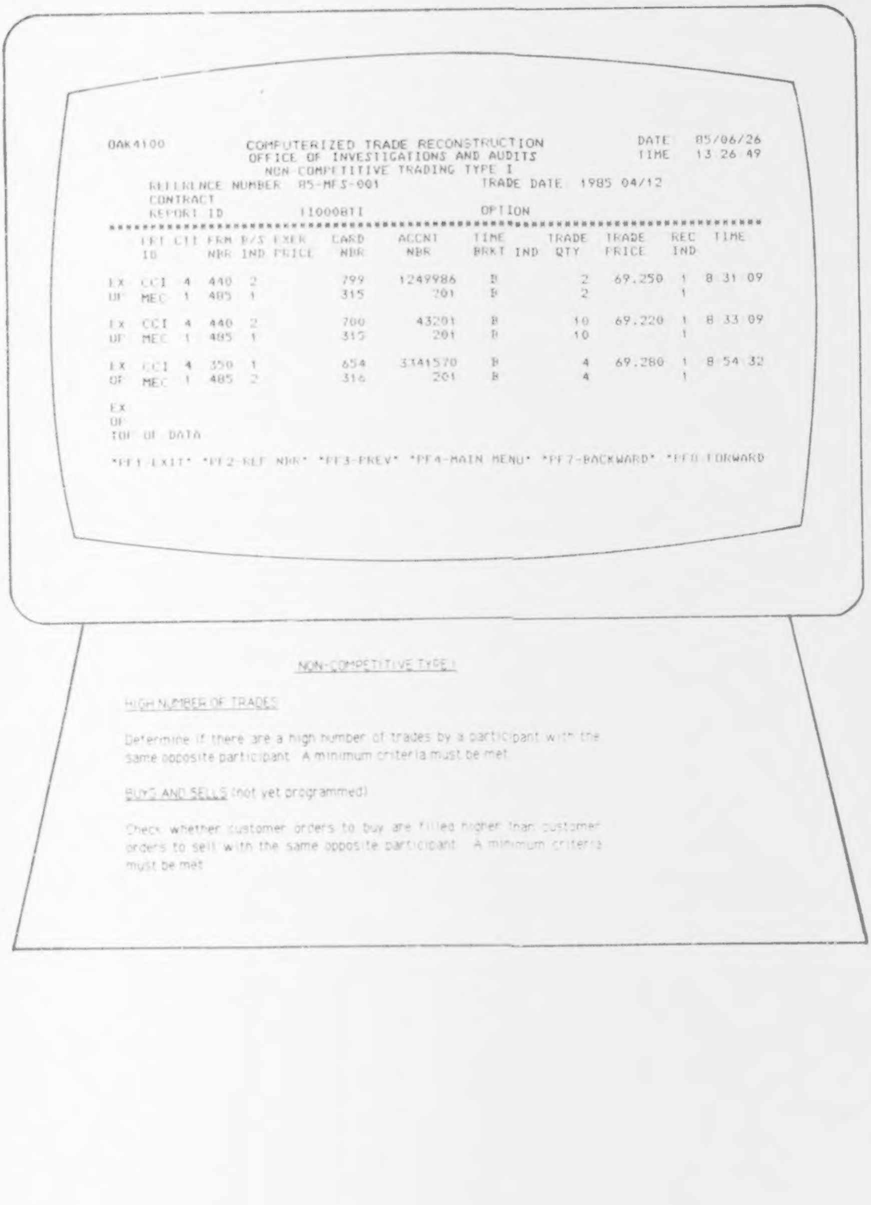
TAKING THE OTHER SIDE

DIRECTLY:

When a participant's personal account is the opposite side of a customer order which he filled.

INDIRECTLY:

If the same participant, trading for his personal account, is on the other side of both customer and personal trades executed by another participant for identical quantities at the same price, or plus or minus 1 [illegible]



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OAK4100          COMPUTERIZED TRADE RECONSTRUCTION            DATE  85/06/26
                 OFFICE OF INVESTIGATIONS AND AUDITS          TIME  13:26:49
                   NON-COMPETITIVE TRADING TYPE I
    REFERENCE NUMBER  85-MFS-001              TRADE DATE  1985 04/12
    CONTRACT
    REPORT ID          11000BTI               OPTION
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    FRT CTI FRM B/S EXER    CARD     ACCNT    TIME       TRADE  TRADE    REC  TIME
    ID      NBR IND PRICE   NBR      NBR      BRKT IND   QTY    PRICE    IND

EX  CCI  4  440  2          799    1249986     B           2   69.250   1  8:31:09
OP  MEC  1  485  1          315        201     B           2            1

EX  CCI  4  440  2          700      43201     B          10   69.220   1  8:33:09
OP  MEC  1  485  1          315        201     B          10            1

EX  CCI  4  350  1          654    3341570     B           4   69.280   1  8:54:32
OP  MEC  1  485  2          316        201     B           4            1

EX
OP
TOP OF DATA

*PF1-EXIT* *PF2-REF NBR* *PF3-PREV* *PF4-MAIN MENU* *PF7-BACKWARD* *PF8-FORWARD
```

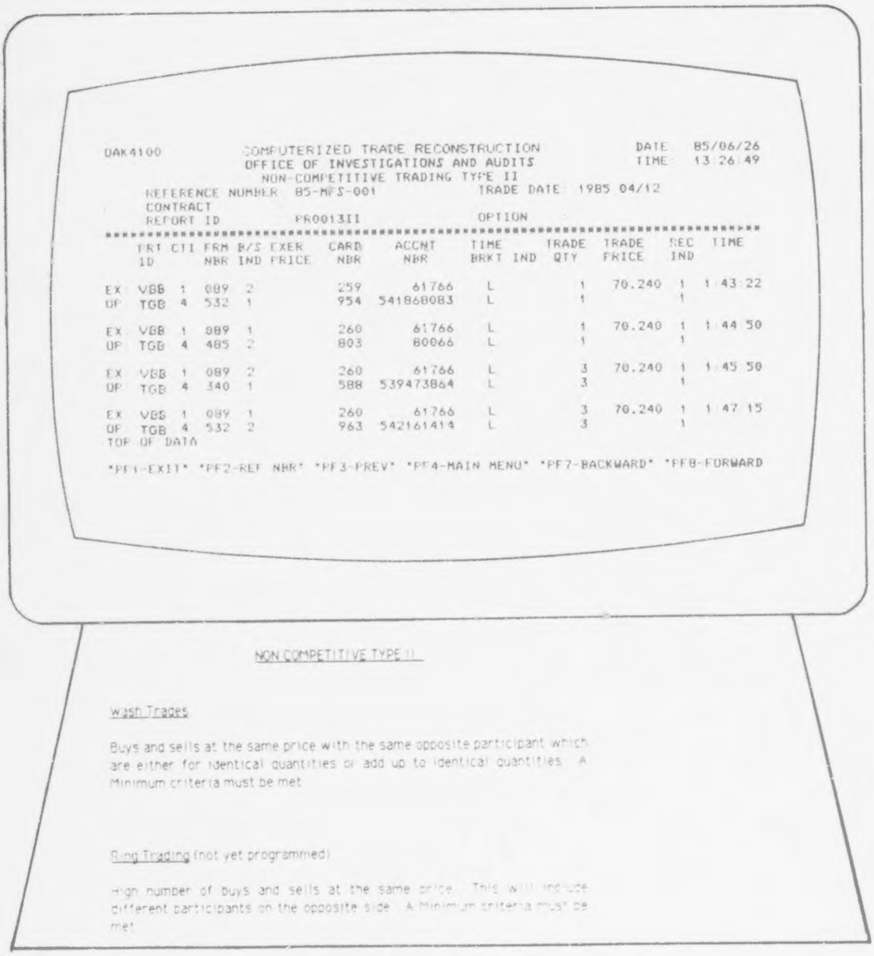
NON-COMPETITIVE TYPE I

HIGH NUMBER OF TRADES

Determine if there are a high number of trades by a participant with the same opposite participant. A minimum criteria must be met.

BUYS AND SELLS (not yet programmed)

Check whether customer orders to buy are filled higher than customer orders to sell with the same opposite participant. A minimum criteria must be met.



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UAK4100          COMPUTERIZED TRADE RECONSTRUCTION          DATE   85/06/26
                 OFFICE OF INVESTIGATIONS AND AUDITS         TIME   13:26:49
                   NON-COMPETITIVE TRADING TYPE II
    REFERENCE NUMBER  85-MFS-001              TRADE DATE  1985 04/12
    CONTRACT
    REPORT ID          PR0013II               OPTION
****************************************************************************
    PRT CTI FRM B/S EXER    CARD     ACCNT     TIME        TRADE  TRADE   REC  TIME
    ID      NBR IND PRICE   NBR      NBR       BRKT IND    QTY    PRICE   IND

EX  VBB  1  089  2          259      61766      L           1   70.240   1   1:43:22
OP  TGB  4  532  1          954  541868083      L           1            1

EX  VBB  1  089  1          260      61766      L           1   70.240   1   1:44:50
OP  TGB  4  485  2          803      80066      L           1            1

EX  VBB  1  089  2          260      61766      L           3   70.240   1   1:45:50
OP  TGB  4  340  1          588  539473864      L           3            1

EX  VBS  1  089  1          260      61766      L           3   70.240   1   1:47:15
OP  TGB  4  532  2          963  542161414      L           3            1
TOP OF DATA

*PF1-EXIT* *PF2-REF NBR* *PF3-PREV* *PF4-MAIN MENU* *PF7-BACKWARD* *PF8-FORWARD
```

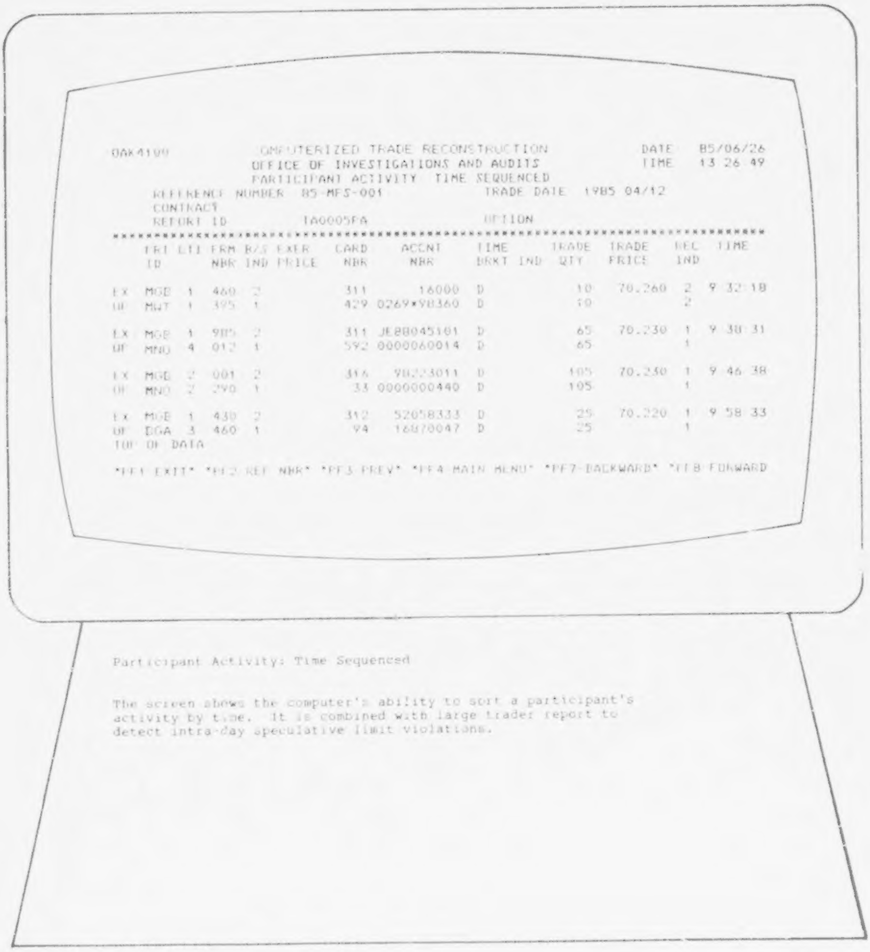
NON COMPETITIVE TYPE II

Wash Trades

Buys and sells at the same price with the same opposite participant which are either for identical quantities or add up to identical quantities. A Minimum criteria must be met.

Ring Trading (not yet programmed)

High number of buys and sells at the same price. This will include different participants on the opposite side. A Minimum criteria must be met.



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OAK4109            COMPUTERIZED TRADE RECONSTRUCTION            DATE   85/06/26
                   OFFICE OF INVESTIGATIONS AND AUDITS          TIME   13 26 49
                   PARTICIPANT ACTIVITY  TIME SEQUENCED
    REFERENCE NUMBER  85-MFS-001             TRADE DATE  1985 04/12
    CONTRACT
    REPORT ID          TA0005PA              OPTION
******************************************************************************
    TRT CTI FRM B/S EXER   CARD    ACCNT     TIME       TRADE  TRADE   REC  TIME
    ID      NBR IND PRICE  NBR     NBR       BRKT IND   QTY    PRICE   IND

EX  MGB  1  460  2          311      16000  D             10   70.260  2  9 32 18
OP  MWT  1  395  1          429 0269*98360  D             10           2

EX  MGB  1  985  2          311 JE88045101  D             65   70.230  1  9 38 31
OP  MNO  4  012  1          592 0000060014  D             65           1

EX  MGB  2  001  2          316   98223011  D            105   70.230  1  9 46 38
OP  MNO  2  290  1           33 0000000440  D            105           1

EX  MGB  1  430  2          312   52058333  D             25   70.220  1  9 58 33
OP  DGA  3  460  1           94   16870047  D             25           1
TOP OF DATA

*PF1 EXIT* *PF2 REF NBR* *PF3 PREV* *PF4 MAIN MENU* *PF7-BACKWARD* *PF8 FORWARD
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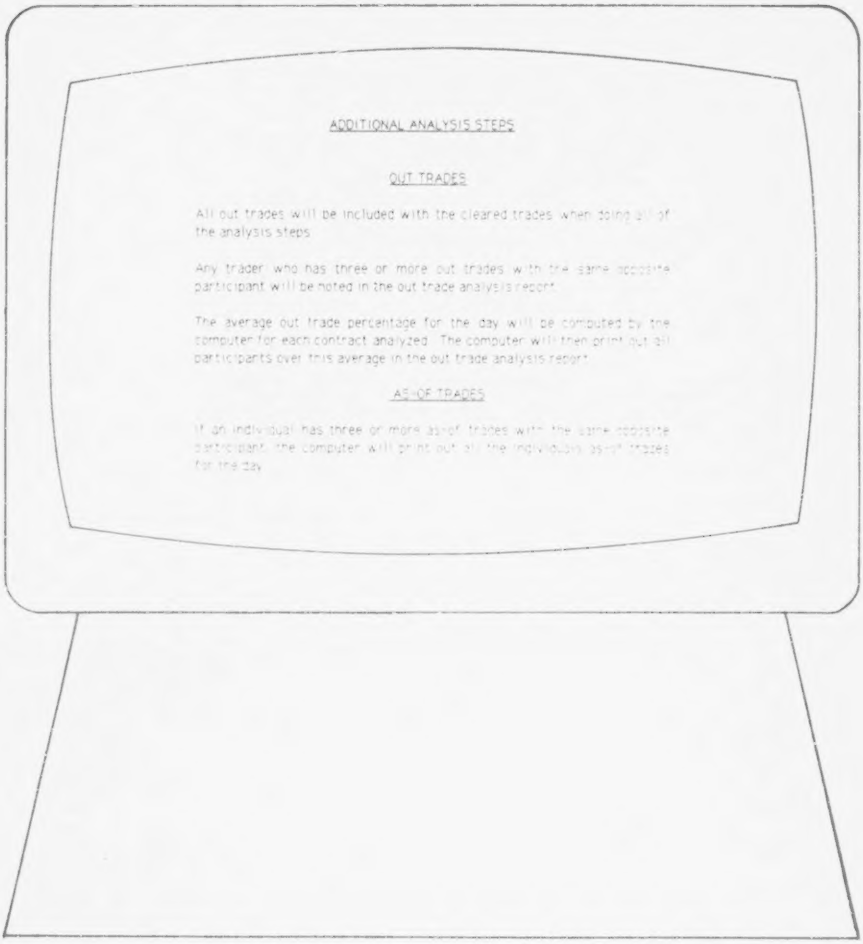
Participant Activity: Time Sequenced

The screen shows the computer's ability to sort a participant's activity by time. It is combined with large trader report to detect intra-day speculative limit violations.



ADDITIONAL ANALYSIS STEPS

OUT TRADES

All out trades will be included with the cleared trades when doing all of the analysis steps.

Any trader who has three or more out trades with the same opposite participant will be noted in the out trade analysis report.

The average out trade percentage for the day will be computed by the computer for each contract analyzed. The computer will then print out all participants over this average in the out trade analysis report.

AS-OF TRADES

If an individual has three or more as-of trades with the same opposite participant, the computer will print out all the individual's as-of trades for the day.

CHRONOLOGY

The Commodity Futures Trading Commission and Exchange Audit Trails

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TABLE OF ABBREVIATIONS

Amex Commodities Corporation	ACC
Chicago Board of Trade	CBT
Chicago Mercantile Exchange	CME
Coffee, Sugar & Cocoa Exchange, Inc.	CSCE
Commodity Exchange, Inc.	COMEX
Kansas City Board of Trade	KCBT
MidAmerica Commodity Exchange	MidAm
Minneapolis Grain Exchange	MGE
New York Cotton Exchange	NYCE
New York Futures Exchange	NYFE
New York Mercantile Exchange	NYMEX
Philadelphia Board of Trade	PHBT

1974 -- In considering the creation of the Commission, Congress debated whether to include in the authorizing legislation the requirement that trades be timed to the minute. After testimony and debate, Congress determined to leave this question to the discretion of the Commission.

1975 November -- The Commission received a report from an advisory committee which recommended that dual trading be permitted, but that a study be conducted of systems which would permit more precise recording of the time of execution of trades.

December -- The Commission published proposed regulations which would permit dual trading to continue, but would require each contract market to develop and implement a system (such as one-minute timing) by April 1977 which would permit the rapid and accurate reconstruction of trading.

1976 April-July -- The Commission established an internal task force to consider whether thirty-minute bracketing was a feasible interim step towards full trade sequence reconstruction. In July, the task force reported that although bracketing would aid reconstruction somewhat, it would be of limited utility and in many instances could result in improper sequencing.

1976 December -- The Commission adopted regulation 1.35(g)(1), which required each contract market, by June 1977, to show on the record of each futures trade "the mechanically or electronically verified time of execution of such futures trade to at least the nearest minute." Adopted regulation 1.35(g)(2) permitted extensions of up to one year to implement such systems, provided the exchanges implemented interim trade-timing systems (such as thirty-minute bracketing).

1977 January-June -- All existing commodity exchanges petitioned under regulation 1.35(g)(2) for extensions of time to comply with regulation 1.35(g)(1).

1978 -- A report of the General Accounting Office ("GAO") prepared for the Commission's reauthorization found fault with the thirty-minute bracketing system then in use, and urged the Commission to move forward with its proposed one-minute standards.

1978 -- In the House of Representatives, an amendment to the Commodity Exchange Act, which later was withdrawn, would have required that members record the minute of trade execution.

1979 February -- The Commission published revisions to regulation 1.35 which would require thirty-minute bracketing, providing that contract markets could prove that thirty-minute bracketing was an appropriate substitute for one-minute timing.

December -- The Commission determined not to adopt the revisions to regulation 1.35 proposed in February 1979, but instead to adopt regulation 1.35a-(T), a temporary (until January 1, 1981) exemption from regulation 1.35(g)(1), which permitted the continued use of thirty-minute bracketing to provide a further opportunity to demonstrate that it was an adequate substitute for one-minute timing.

1980 September -- Commission staff issued a memorandum on the accuracy of bracketing and its effectiveness in reconstructing trading, in which it stated that the accuracy rate was not sufficient, and that even if it was, bracketing in many instances would not aid in trade reconstruction.

November -- The Commission published final regulations eliminating the one-minute timing requirement of regulation 1.35(g), and substituting the thirty-minute bracketing requirement of temporary regulation 1.35a-(t).

1981 June -- The Commission proposed that commodity option trading under its proposed three-year pilot program include a requirement that option transactions be timed to the minute. The proposal was not adopted so as to make the option timing requirement generally the same as that for futures. However, an additional time-stamp, at the time an option order is phoned down to the trading floor, was required for options as the part of the final regulations.

1982 June -- In hearings before the House Committee on Energy and Commerce, Representatives Wirth and Dingell criticized the Commission for not requiring improvements in commodity exchange audit trails by adopting the Commission's earlier proposed one-minute timing standard.

July -- A GAO report prepared for the Commission's 1982 reauthorization criticized the Commission's capitulization to industry pressure in retreating from its one-minute trade timing standard. The GAO called this a failure of the Commission's rulemaking authority.

1983 October -- The CBT and CME rule enforcement reviews reiterated recommendations from 1982 rule enforcement reviews that automated trade practice surveillance systems be developed and that the exchanges develop improved audit trails.

1984 January -- The Commission approved rules which permitted the New York Mercantile Exchange ("NYMEX") to change from its one-minute timing system to a thirty-minute bracketing system. At about the same time the Commission had begun raising questions regarding the efficacy of thirty-minute bracketing systems, and had directed the staff to respond to those questions. NYMEX then decided not to implement the thirty-minute bracketing rules, but instead determined to seek to adopt their one-minute system to increased trading volume.

February -- Commission staff members met with SEC staff members to discuss audit trails in the securities markets and the SEC's efforts in that regard.

January-September -- Commission staff did background research on thrity-minute bracketing, including exchange accuracy reports on the amount and quality of bracketing data that are captured, the use of bracketing data in exchange and commission investigations (some exchanges stated that bracketing data was not used in their investigations), and alternatives to thirty-minute bracketing, both in systems in use at commodity exchanges and systems in use elsewhere. This background research included visits to all commodity exchanges, plus the Chicago Board Options ("CBOE") Exchange and the New York Stock Exchange ("NYSE").

September -- In response to its request in January 1984, the Commission received a memorandum from the Division of Trading and Markets entitled "Thirty-Minute Bracketing and Exchange Audit Trail Systems," which stated that the current system of thirty-minute bracketing had inherent flaws and limitations, especially in an era of increasing volume on the exchanges, which rendered that system inadequate in many instances to surveil the markets adequately.

September -- The Commission released its Congressionally-mandated report on insider trading, and noted that it intended to require improvement in exchange audit trails in order more effectively to deter and detect the type of "insider trading" that results when dual trading floor brokers trade ahead of customer orders.

November -- The Commission released its study of the volatile prices in the soybean market which occurred early in the fall of 1983, a situation which prompted the Joint Economic Committee headed by Senator Jepsen to hold hearings in Chicago. In releasing the report, the Commission noted the need for improved audit trails.

November -- Trading and Markets staff visited the CBT, CME, Mid-America Commodity Exchange, CBOE, and NYSE to discuss exchange audit trail systems and market characteristics with exchange staff and certain exchange executives.

September-December -- Commission staff continued to research the issue of improved audit trails, and at the Commission's request, developed language for proposed amendments to regulation 1.35(g).

December -- The Commission proposed amendments to its then-current regulation 1.35(g). These amendments ultimately would have required a technology-assisted trade timing system to record trade times to the nearest minute and a two-step implementation, the first step being manual recordation.

December -- The Commission, the Federal Reserve Board and the SEC issued their study on the effects on the economy of trading futures and options, the so-called "Fed Study." In that study, both the Federal Reserve Board and the SEC supported the Commission's efforts to improve contract market audit trails, stressing the importance of a good audit trail for inter-market, was as well as intra-market, surveillance.

1985 February -- The Futures Industry Association and most commodities exchanges joined in a letter requesting that the Commission extend the formal comment period for the proposed rules beyond the February 25, 1985 closing date. The Commission responded by extending the comment period to April 26, 1985.

March -- Commission staff from Trading and Markets and the Automated Data Processing Section met to discuss the additional research needed to be undertaken. The ADP section later developed a plan of action first to identify the physical and operational facilities at each exchange, including technological capabilities, and then to analyze potential technological applications to these environments.

April -- Commission staff briefed staff from the General Accounting Office ("GAO") regarding the Commission's proposed views in connection with the GAO's limited study of this issue.

April -- ADP staff visited each commodities exchange, plus the Chicago Board Options Exchange and the New York Stock Exchange. In addition to reviewing the exchange environment and technical capabilities, ADP staff asked questions of exchange officials and left with each exchange a survey for the exchange to complete regarding the characteristics of its markets.

April -- The New York Cotton Exchange ("NYCE"), as part of its comments on the proposed rules, submitted a reconstruction of trading for one thirty-minute bracket (140 transactions) for its cotton contract, and a second reconstruction of one broker's trades (86 transactions) for an entire day. These reconstructions of a relatively slow market required the equivalent of one person working 56.25 days to complete, and in the case of the reconstruction of the individual broker's trades, was not able to definitively assign a time in 20 percent of the transactions.

April -- Also as part of its comments, the NYCE submitted its proposal for improving its audit trail, which included fifteen-minute (as opposed to thirty-minute) brackets, submission to clearing of both entry and exit time-stamps for customer orders, and the numbering and sequencing of trading cards.

April -- The CBT, as part of its comments, submitted a proposed alternative audit trail system which included the submission of exit times for customer orders, the use of thirty-minute brackets for all orders, and the assignment of times to trades from the time and sales register. The CBT Executive Committee later presented the Exchange's alternative proposal to the Commission at a meeting in Washington.

May -- As part of its comments on the Commission's proposed audit trail rules, the CME submitted an alternative audit trail proposal which included the submission of exit times for customer orders, the requirement that certain dual traders record the minute that they execute trades for their personal accounts, that each trade be submitted with an account number, and that the submission of account numbers and exit times be a prerequisite to sending a trade on to clearing. Senior Exchange officials later presented the CME's proposed alternative to each Commissioner.

May-December -- Trading and Markets staff gathered information and data for each exchange regarding the characteristics of trading on such exchanges, including the breakdown of orders by order type, the amount of trading executed on the open and close, the amount of orders by customer type indicator, and a number of other categories relevant to the trading at each exchange.

May -- Trading and Markets staff visited the CBT and CME staff and discussed flashing and other audit trail issues which had been raised in comments by exchanges.

May -- Trading and Markets staff sent audit trail comment letter to the GAO.

May -- Trading and Markets staff met in Washington with an official from the Coffee, Sugar & Cocoa Exchange, Inc. ("CSCE") to discuss the Exchange's comments on the proposed rules, particularly the CSCE's ability to reconstruct trading.

June -- Trading and Markets staff met with exchange officials at the Commodity Exchange, Inc. ("Comex") and the Amex Commodities Corporation to discuss these exchange audit trails and plans for improving their system.

June -- At the invitation of the Futures Industry Association, Trading and Markets staff met with futures commission merchants in New York to hear their views on the issue of exchange audit trails.

June -- Trading and Markets staff in Chicago met with officials at the CBOE to discuss the exchange's efforts in implementing its improved audit trail system. At that time Trading and Markets staff left with exchange officials questions regarding the exchanges' audit trail proposals and the characteristics of their markets.

June -- Trading and Markets staff prepared and distributed to the Commission a "Summary of Comments" based on the 58 comment letters received. This document did not in any way evaluate the comments, but instead grouped the comments according to the specific issues raised or opinions expressed.

June -- The ADP staff circulated initial drafts regarding the then-existing technological systems and capabilities in use at each exchange.

June -- Trading and Markets staff in Chicago did a limited survey of the volume and transactions on the open and close of trading in active month CBT soybeans.

June -- Commission staff investigated price repetition in four active contracts, CBT Treasury Bonds and soybeans, and CME live hogs and Canadian dollars.

June -- Trading and Markets staff member met with an SEC staff member regarding the SEC audit trail requirements.

June -- Commissioner Hineman sent a memorandum to Trading and Markets staff regarding his views on what a "performance standards" entails.

June -- The Commission's regular Agricultural Advisory Committee meeting addressed the issue of exchange audit trails and the Commission's proposed rules.

June -- Trading and Markets staff in Chicago reviewed CBT and CME audit trail capabilities as reflected in each exchange's investigatory files, and generally found that the lack of adequate data significantly increase the time required for investigations, often resulted in investigations for which there was inconclusive evidence whether violations did or did not occur, and in many instances investigations of suspect trading were not even initiated because of the lack of adequate data. Further, an informal GAO review of CBT investigative files revealed that half of open investigations included a trade timing issue.

June -- The Commission's Financial Products Advisory Committee meeting addressed the issue of exchange audit trails and the Commission's proposed rules.

July -- The Division of Trading and Markets sent letters to all exchanges requesting detailed information regarding the characteristics of trading on each exchange.

July -- Trading and Markets staff from Washington, New York and Chicago met in Washington to discuss the comments received, the information developed by the ADP section, and possible alternatives for the final rule.

July -- Trading and Markets staff sent late-received audit trail comment letters to the GAO.

July -- Discussion and correspondence between the Comex and Commission staff regarding Comex's efforts to develop a hand-held trading card device which, upon activation by a member, would print the minute of execution on the appropriate line of trading card, where essential trade information is written by the member. These efforts also were communicated to the Commissioners by senior representatives of Comex at a meeting in Washington.

July -- Trading and Markets staff discussed with the staff of the New York Futures Exchange ("NYFE") that Exchange's proposal to improve its audit trail by requiring its members to record manually the minute of execution.

July -- Chicago Trading and Markets staff again visited the CBOE to discuss that Exchange's ongoing efforts to improve its audit trail by requiring that members manually record the minute of execution.

July -- The Commission's ADP section demonstrated to Commissioners potentially applicable technological components for exchange audit trail systems. Included was a demonstration by Infocel, an information appliance company, of a bar code reader which potentially could be adapted to the auction market trading environment.

July -- Trading and Markets staff went to Chicago to see demonstration of a prototype of the proposed CBT audit trail alternative.

August -- Chicago Trading and Markets staff discussed audit trail issues and alternatives with CME and CBT floor members, and found one member who currently times his trades to the minute. This discussion also included the potential use on the CBT and CME trading floors of a multi-part trading card used at CBOE, which another exchange member stated could be adapted to the commodity exchange floor.

August -- Commission staff went to Chicago to see a demonstration of a prototype of the proposed CBT audit trail alternative. As in the case of the July demonstration, Commission staff asked questions and commented to CBT staff regarding their concerns about the proposed alternative.

August -- CBT staff came to Washington to demonstrate the prototype of their alternative proposal to Commissioners and Commission staff. Again, there were questions and discussion.

August -- The Commission's ADP section sent an informational memorandum to the Commission regarding their investigation of technological components which potentially could be adapted to systems for improved audit trails.

August -- Chicago Trading and Markets staff again visited the CME and CBT regarding issues related to audit trail.

August -- The Division of Trading and Markets sent to the Commission a background memorandum entitled "Order Flow on the Contract Markets." This document traced the flow of an order from the time it is placed by a customer, through transmission to the exchange floor, execution, submission of trading information to clearing, and report of the trade to the customer, noting the differences between methods and systems on the various exchanges.

September -- Trading and Markets staff discussed the audit trail proposals of the various exchanges and the potential final Commission rules with staff of the GAO in connection with the GAO's limited study of the issue of exchange audit trails.

September -- The Division of Trading and Markets sent to the Commission a background memorandum regarding the peak load opening and closing periods of trading on the contract markets. The memorandum stated that during the opening and closing thirty-minute brackets that generally the amount of personal trades, and trading volume is relatively higher during these periods.

September -- Chairman Phillips and Commission staff were given an oral presentation of the findings of the GAO's limited study of the issue of exchange audit trails, in which the GAO supported the Commission's proposed one-minute trade timing standard, but stated that such a standard would be effective and achieve its intended goals only if rigorously enforced. The GAO also stated its intention to send the Chairman a letter setting forth its view.

October -- The Division of Trading and Markets sent a memorandum to the Commission regarding the flashing of order, price and execution information on the contract markets. This memorandum stated that flashing was becoming an increasingly used method of order information transmission on the busiest markets at the CBT, CME, and the NYFE, where it accounted for up to 65 percent of orders, but was little used on other exchanges.

November -- The Division of Trading and Markets sent a memorandum to the Commission regarding its analysis of all aspects of the audit trail issue, as well as proposed amendments to Commission regulation 1.35 and a proposed Federal Register release.

December -- The Commission staff briefed the Commissioners regarding all aspects of the audit trail issue. Staff answered questions regarding the proposed rule and Federal Register release, and was directed to obtain certain additional information.

December -- Commission staff from Washington and Chicago briefed Commissioners Seale and Hineman and their assistants regarding current market reconstruction capabilities, including reconstruction techniques and capabilities in the case of intra-day speculative limit violations. Discussion also focused on exchange reconstructions, and how the lack of effective data hampered exchange and Commission investigations of potential trading abuses.

December -- Commissioner Davis sent a memorandum to fellow Commissioners regarding his proposed changes to the proposed Federal Register release.

December -- Chairman Phillips received a letter from the GAO which was distruted to other Commissioners and Commission staff, regarding the GAO's views on the issue of exchange audit trails and the Commission's proposed one-minute standard (See September entry regarding GAO staff meeting with Chairman Phillips).

December -- The Commission received from the CBT a final version of its earlier economics study, a time and motion study, and a study of potential technological applications to improved contract market audit trails.

December -- The Division of Trading and Markets (with support from the Division of Economic Analysis) sent to the Commission a memorandum analyzing the issues and statements presented in the three CBT studies.

December -- The Division of Trading and Markets prepared an audit trail briefing book, which was received by all Commissioners.

December -- Trading and Markets staff visited the NYSE to again review that Exchange's audit trail. A memorandum regarding the NYSE audit trail also was prepared by Trading and Markets staff for Commissioner West.

1986 January -- Prior to the meeting at which the proposed final audit trail rules were to be voted on, Chairman Susan Phillips travelled to Chicago to brief industry leaders on the major aspects of the proposed final rules.

January -- On January 14, the Commission unanimously approved amendments to regulation 1.35 which:

1. Removed the requirement that members record the time of execution on their trading cards, unless so required by exchange rules approved by the Commission.
2. Required that the minute of execution be placed on each exchanges' 1.35(e) record (trade register) for each party to each trade.
3. Permitted an exception to the above rule by permitting only one time (minute) of execution to be captured by exchange-recorded trade timing systems.
4. Permitted separate identification and timing of the peak load opening and closing of trading where appropriate rules were submitted to and approved by the Commission.

5. Did not specify the means by which the time is placed on the trade register.

February -- Chairman Phillips and senior Commission staff travelled to Chicago to hear an oral presentation of a joint CBT-CME audit trail proposal that included the use of entry times for customer trades, sequenced trading cards for personal trades, and imputed trade times based on computer searches of these and time and sales register data.

February -- CBT and CME staff travelled to Washington to make a two-day oral presentation to Commission staff regarding their joint audit trail proposal. Again, the Commission received nothing in writing on this proposal, the specification of which evolved and changed during the course of the dialogue between CBT, CME, and Commission staff members.

February -- Following the oral presentation in Washington by CBT and CME staff to Commission staff, and an initial evaluation by Commission staff, Chairman Phillips telephoned senior CBT and CME officials in Chicago to inform them that although it appeared that the concept presented could potentially meet the requirements of the rule, more precise information and fine-tuning of the concept presented may be needed.

February -- Chairman Phillips, senior officials of the CBT and CME, and other interested persons testified before the Senate Agriculture Committee on audit trail and other issues.

February -- Following the Senate hearings, Chairman Phillips sent a letter to the CBT and CME, again offering to work with the Exchanges on their proposal and requesting that this proposal be committed to writing.

February -- Chairman Phillips received a letter from Senator Lugar requesting that the Commission contact the Chicago exchanges to discuss their audit trail proposal.

February -- Chairman Phillips received a letter from the CBT and CME responding the Chairman's letter, which stated that the question was not whether the CBT-CME proposal could meet the requirements of the Commission's audit trail rule, but whether their proposal could achieve an effective audit trail. The letter also offered to present another demonstration of the proposed system in Washington, and included a brief written description of the proposed system.

February -- The CBT and CMF made an oral presentation regarding their proposed audit trail system to Commissioners and Commission staff in Washington.

February -- The Commission's Agricultural Advisory Committee, in a regularly scheduled meeting, was briefed on the audit trail issued by Commissioner Hineman and Commission staff.

March -- Chairman Phillips received a letter from the CBT and CME in which the Exchanges stated their view that their proposed system will meet the requirements of the Commission's audit trail regulations, and offering to continue to work with the Commission on this issue.

APPENDIX

FEBRUARY 19 HEARING

STATEMENT OF HON. JESSE HELMS, A U.S. SENATOR FROM NORTH CAROLINA

Let me say again that I regret the necessity of my arriving late for this initial hearing on the subject of the reauthorization of the Commodity Future Trading Commission, as I indicated, I had agreed to chair the confirmation hearings for two very important U.S. ambassadorial appointments in Central America.

There is no more important economic activity in this country than futures trading. The price discovery function associated with most of these markets help farmers and processors to price their wheat, cotton, cattle, soybeans, corn, and other commodities on which futures contracts are based. The prices for these commodities are determined through the interaction of free market forces in a pit or ring. Anyone who wants to buy or sell a specific commodity can do so through a professional agent acting on his behalf.

In addition to price discovery, these markets serve the important function of shifting the risk associated with price changes. The risk is shifted from those who want to avoid it to those who willingly embrace it in the hope of making money. For example, the flour miller makes his profit from milling wheat into flour, not from unanticipated shifts in the value of the wheat that he holds in inventory. The miller can use the futures markets to shift the risk associated with adverse changes in the value of his wheat inventory to someone who is trying to profit from just such a change. This permits the miller to concentrate on what he does best, milling flour, without having to worry about economic forces in the grain market over which he has no control.

I would be remiss, if I did not say a few words about agricultural options. I believe these options offer producers, elevator operators, agricultural bankers, and other an opportunity to lock in a market price, and thus limit the risks associated with downward price movements, while leaving open the opportunity to sell at a higher price if the market rises. As our agricultural economy moves toward the free market, farmers will have a greater incentive to investigate and use these marketing tools. These tools will also help the farmer to develop and implement marketing strategies that ensure profitability, rather than leaving the marketing of his products to whim, guesswork, or the demands of creditors. I am hopeful that the industry and the Commission will work together to expand the use of agricultural options as quickly as is prudent.

In order to ensure that the benefits from futures and options trading continue to flow, it is important to have a viable Commission that can serve as a good "traffic cop". This Committee has done everything it can to ensure that intelligent, thoughtful people are appointed to the Commission; and I believe its current members are well qualified to carry out their statutory charge.

I am hopeful that these hearings will give this Committee an opportunity to renew its legislative oversight of the Commission, as well as to hear testimony on the specific legislative proposals put forward by the Commission in S. 2045. I look forward, Mr. Chairman, to both reading and hearing the testimony of the witnesses who will testify during the reauthorization process.

STATEMENT OF HON. EDWARD ZORINSKY, A U.S. SENATOR FROM NEBRASKA

Mr. Chairman, I am glad that the Committee is holding this series of hearings to consider legislation relating to the Commodity Futures Trading Commission.

The futures markets are an integral part of the Nation's economy. They affect consumers, investors, financial institutions, manufacturers, Government, and Businesses of all types, including the wheat, corn, and soybean farmer, as well as the beef and pork producer. Therefore, it is imperative that the markets be free from fraud and manipulation. The CFTC has the primary responsibility for ensuring fair and honest trading of futures contracts on the commodity exchanges.

The CFTC was established as an independent regulatory agency in 1974 by the Commodity Exchange Act and provided for Federal regulation by the Commission of all agricultural and other commodities, goods, and services traded on exchanges.

The legislation (S. 2045) that the Committee has under consideration was introduced by Chairman Helms and Senator Lugar at the request of the Commission. This bill would reauthorize the CFTC and its activities for six year. Previous reauthorization were for four years, the latest in 1982.

The 1982 legislation dealt with a number of difficult issues. These included private rights of actions, agricultural option, leverage transactions, and State anti-fraud jurisdiction. In addition, jurisdictional accord between the CFTC and the Securities and Exchange Commission was established, and the futures industry was given greater authority for self-regulation through the National Futures Association.

This year the CFTC is seeking relatively modest changes in its statutory authorities, and I am hopeful that the Committee will be able to complete action on this legislation in an expeditious manner.

The issues that are addressed in the bill are in the areas of enforcement and litigation, regulation of leverage transactions, registered futures associations, and restriction on certain investments by CFTC personnel.

The bill contains provisions that should enable the Commission to operate more efficiently and effectively. Some of these provisions relate to judicial review of CFTC final orders and rules, service of subpoenas outside the territorial jurisdiction of the United States, and the appointment of temporary ex parte receivers to protect business records and assets. Other provisions would expand CFTC authority to review and alter rules issued by the National Futures Association and would simplify CFTC procedures for the review of disciplinary actions and denial of membership by the Futures Association.

The bill also would prohibit fraud in connection with any futures transactions and would eliminate the requirement in current law for the CFTC to separately regulate leverage transactions.

Current law prohibits fraud in futures contracts conducted on any contract market. The bill clarifies the authority of the Commission to pursue off-exchange operators who engage in fraudulent activities.

I understand that the Commission was not unanimous in recommending the provision to eliminate regulation of leverage transaction. Apparently, the majority of the Commission believes the leverage transactions are indistinguishable from future contracts and should be traded as such. The minority apparently is of the opinion that continued separate regulation is warranted. I look forward to hearing testimony on this issue not only from CFTC officials but also from representatives of the affected industry.

Mr. Chairman, the reauthorization of CFTC is one of the most important responsibilities of this Committee. I am pleased that we will have an opportunity to hear and consider testimony from such a diverse group of witnesses.

STATEMENT OF HON. PATRICK LEAHY, A U.S. SENATOR FROM VERMONT

Mr. Chairman, I am pleased that the Committee is conducting these hearings on reauthorization of the Commodities Futures Trading Commission early in this session of the 99th Congress. We are all familiar with the difficulties that can be encountered when legislative action is postponed until late in the year -- our recent experience with the farm bill is a testament to difficulties in scheduling. The 1985 farm bill barely escaped being the 1986 farm bill.

Some of us here at the table were active in the establishment of CFTC and its reauthorization in 1982. The 1986 reauthorization will -- hopefully -- not prove to be as thorny a thicket to cross.

However, certain issues related to the Commission's oversight activities must be thoroughly reviewed by the Committee. In particular, the Commission's recent regulations concerning trade reconstruction -- the so-called "audit trail" -- will be a matter of some concern to me and, I am sure, many of my colleagues.

In all, compared to earlier legislative action, the 1986 agenda seems modest. For example, the need for the general role of CFTC has been established, and in 1982, Congress codified the distinct roles of CFTC and the Securities and Exchange Commission.

Certain issues involved in the reauthorization will be somewhat difficult. Two of these issues -- whether or not to exclude leverage transactions from CFTC regulation and whether or not to expand the CFTC's jurisdiction to include policing off-exchange futures transactions -- may be controlversial. Other issues in the reauthorization -- such as authority to serve investigory subpoenas, authority to seek appointment of a temporary ex parte receiver, or provisions that affect CFTC employees -- appear to be relatively straight-forward and do not promise to take a great deal of the Committee's time.

The reauthorization bill introduced by Senators Helms and Lugar, by request, strikes statutory references in the Commodity Exchange Act to the regulation of leverage transactions. While a majority of Commissioners recommended eliminating leverage transaction regulation as a separate statutory category, that recommendation is not unanimous. The Commission majority view, as I understand it, holds that leverage transactions are indistinguishable from futures contracts. Futures contracts must be traded on exchanges, in a supervised environment. Consequently, in the view of the majority of the Commission, leverage transactions do not justify separate statutory references.

The CFTC's request bill expands the jurisdiction of the CFTC to pursue off-exchange operators perpetrating fraud. Certainly no one condones fraudulent activity, and all of us would like to see fraud in any form prosecuted to the extent of the law permits. However, the main mission of the CFTC involves regulation of the exchanges. I consider adequate fulfillment of that mission to be vital. Diffusing resources by utilizing personnel and budget to police off-exchange activity may not be wise.

Mr. Chairman, I look forward to reviewing the statements of the witnesses.

STATEMENT OF HON. ALAN J. DIXON, A U.S. SENATOR FROM ILLINOIS

Mr. Chairman, I am pleased to be here today as we begin a series of hearings on the reauthorization of the Commodity Futures Trading Commission.

I believe the futures industry is an important element in our economy, especially in our agricultural economy. For this reason, I introduced an amendment, which was accepted, during debate on the 1985 farm bill. This amendment provides for a pilot program and study designed to encourage expanded education and use of the futures industry by farmers.

I hope that this amendment, administered by the Department of Agriculture in cooperation with the Commodity Futures Trading Commission, will increase public awareness about the futures industry.

STATEMENT OF HONORABLE SUSAN M. PHILLIPS, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION BEFORE THE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY, UNITED STATES SENATE, FEBRUARY 19, 1986.

I am pleased to come before the Committee today representing the Commodity Futures Trading Commission to update you on develop-pments at the Commission since its Congressional reauthorization in 1982 and to present our legislative proposals for the 1986 reauthorization. While the Commission's reauthorization in 1978 and 1982 involved major revisions to the Commodity Exchange Act, the Commission does not believe that such extensive revisions are necessary at this time. Our legislative request is short, and it includes a request that the Commission be reauthorized for six years.

Before discussing our brief legislative requests, let me take a moment to report on our experience with the 1982 amendments to the Act.

I. CFTC Experience With 1982 Amendments

A. One-Year Statutory Review Limitation on Contract Market Designations

The Commission has successfully been able to meet both the letter and intent of the 1982 amendment to Section 6 of the Act which requires the Commission to complete action on contract market designations within one year from the time they are submitted to us. The amendment allows the Commission to stay the running of the one-year period upon notice to an exchange that its application is deficient. Implementation of this amendment has required the Commission and the exchanges to change some of their operating procedures, resulting in a somewhat more formal interchange. Nevertheless, the experience under these procedures has been generally positive.

Since January 11, 1983, the effective date of the statutory one-year review period, the Commission has timely designated contract markets for 32 futures and 21 options. Two of the options approved were based on physical commodities (American Commodity Corporation gold bullion and Philadelphia Board of Trade Eurodollars) and involved new exchanges, while the remaining 19 were based on existing futures contracts.

On certain complex designation applications the Commission has found it necessary to notify a board of trade of deficiencies more than once. This occurred almost exclusively when an exchange's response failed to correct fully the deficiencies specified in the Commission's original notice. In other cases, less pervasive problems that did not require significant contract modifications or substantial additional exchange analysis was communicated to an exchange informally by telephone, and the exchange replied within a specified period without any interruption of the one-year review period.

In addition to providing exchanges with a new degree of assurance that their applications will be expeditiously processed, we believe the amendment also provides clarity to the designation process by delineating the exchanges' responsibility for contract justification and the Commission's responsibility for review.

B. 180-Day Time Limitation for CFTC Review of Proposed Exchange Rule Changes

Section 5a(12) of the Act, which outlines procedures for Commission review of proposed exchange rule changes, was substantially restructured by the 1982 Act. In addition to reducing the number of rule changes that must undergo extensive Commission review, the 1982 amendments limited to 180 days the time the

Commission may take to consider proposed rule changes of contract markets.

I am pleased to report that the Commission and its staff have adapted successfully to the constraints imposed on the rule review process by the 1982 amendments. In particular, the Commission has made numerous changes to streamline the rule approval process. Accordingly, the staff has been delegated authority to approve many routine, non-substantive rule amendments. Further, the Commission has recently adopted new rules that grant advance approval to certain types of routine, non-discretionary exchange rule amendments.

The Commission has approved over 1,278 proposed rules and rule amendments in the three years since this change to the Commodity Exchange Act became effective. This figure does not include the hundreds of rules and rule amendments that have been approved in conjunction with the designation of new contract markets.

Our data reveal that action was taken on approximately 43 percent of proposed exchange rule submissions within one month and an additional 26 percent within three months. Of the remaining 31 percent of the submissions, roughly one-third (11 percent of total submissions) required the full six months. Those rule submissions which did take over six months, such as the linkage between the Chicago Mercantile Exchange and the Singapore International Monetary Exchange, were all completed under the voluntary time extensions agreed to by the exchanges involved.

C. Reparations Program

Congress also authorized changes in the Commission's reparations program in the Futures Trading Act of 1982. Those changes have been incorporated into our rules and regulations and have been effective since April 23, 1984.

The new rules created an entirely new voluntary decision procedure, analogous to arbitration, in which the parties unanimously elect to have a Commission Judgment Officer decide their dispute on the basis of documentary evidence and pleadings. The decision is not appealable to the Commission or a U.S. Court of Appeals. Approximately 20 percent of the cases filed since the new rules became effective have been processed through the voluntary procedure. The new rules also retain the summary procedure, in which decisions may be rendered upon documentary proof only, and the formal procedure, where oral hearings before an Administrative Law Judge are routinely held. However, the monetary limit for claims qualifying for the formal procedure has been raised from $5,000 to $10,000.

Among other things, the new rules also: (1) authorize motions for dismissal after a case has been assigned to a Judgment Officer or ALJ; (2) require expedited discovery; (3) limit to twenty major U.S. cities the possible locations for reparation hearings; (4) authorize dismissal of parallel proceedings; (5) delegate authority to the Chief of the Opinions Section to rule upon procedural motions in cases that have been appealed to the Commission; and (6) provide for direct appeals to the Commission rather than a two-step petition process.

The Commission believes the new rules have been beneficial. Because the quality of complaints filed with the Commission is higher, fewer cases are being terminated. Of the 454 complaints filed in FY 1985, only 82 were terminated due to lack of jurisdiction or deficiencies in the filing. The increased quality of the complaints is due to increased communication with the public through responses to about 6,400 phone calls, 800 letters, and requests for 1,700 brochures per year.

Those cases which are filed are receiving expeditious treatment. Once any deficiencies in the filing have been corrected and all respondents have filed answers, the complaints are forwarded for disposition. The disposition of cases in the voluntary proceedings is taking an average of 75 days; cases forwarded for summary or formal proceedings are taking about 136 days, on the average.

Since the new rules have gone into effect, the Administrative Law Judges and Judgment Officers have made major strides toward reducing the backlog of cases awaiting disposition. On March 31, 1984, (three weeks prior to the effective date of the new rules), these presiding officers collectively had a caseload of 905 cases. As of June 30, 1985, this figure had declined to 514. Correspondingly, the time from when a case is assigned to an Administrative Law Judge or a Judgment Officer to when a decision is rendered has decreased significantly.

As for the Commission's appellate docket, the number of reparations appeals has remained fairly constant over the last three years: 136 matters were filed in Fiscal Year 1983; 126 were filed in Fiscal Year 1984; and 139 were filed in Fiscal Year 1985. In contrast, Commission productivity (defined in terms of outgoing CFTC appellate opinions and orders) has nearly doubled over the same period: 108 orders and opinions were issued in Fiscal Year 1983; 168 such orders and opinions were issued in Fiscal Year 1984; and 195 such orders and opinions were issued in Fiscal Year 1985. This rate of Commission productivity is the highest in the agency's history.

The total backlog of reparation cases on the CFTC's appellate docket has decreased from 177 cases on September 30, 1983, to 135 cases on September 30, 1984, and to 101 cases on September 30, 1985. Moreover, the relative age of the appellate backlog is decreasing steadily. On September 30, 1984, there were 51 reparation appeals that had been pending on the Commission's appellate docket for more than one year. By September 30, 1985, no reparation case was pending on appeal for more than one year, and the median age of all such cases on the Commission's docket was six months.

D. SEC-CFTC Relations

Since the enactment of the jurisdictional accord in the 1982 amendments, the Securities and Exchange Commission and the CFTC have continued their cooperative relationship, which has become more structured under the terms of the accord. Certainly, before the accord, the CFTC sought comment on applications relating to exempt securities and financial instruments which might have affected SEC regulatory oversight in the securities markets. But, because the SEC now has an enhanced statutory role in the consideration of futures contracts on stock indexes, the CFTC-SEC relationship is more formal.

The staffs of the Commission and the SEC meet regularly to assure regulatory coordination between the two agencies. One topic of these discussions has been the "third Friday phenomenon." As you may have read in the business and financial press recently, concern has been expressed about volatility in the underlying stock market during the last trading day of the stock index futures and option markets. The Commission and the SEC are considering this development to determine the appropriate regulatory response. Futures market participants in certain over-the-counter stock index contracts presently are required to decrease market positions to prescribed limits as the expiration day approaches. While the Commission is monitoring the effects of this "telescoping" of positions, the limited trading activity in these over-the-counter contracts to date has precluded an empirical assessment of the effects and effectiveness of these regulations.

E. Federal/State Relations

The Futures Trading Act of 1982 contained three major statutory amendments designed to involve the states more extensively in actions against those who engage in unlawful conduct with a "commodity" theme. First, a new "open season" provision was added as Section 12(e) of the Act, which authorizes state officials to enforce their own laws against persons engaging in unlawful commodity transactions or persons who are required to be registered under the Act but are not. Under this amendment, state law enforcement agencies have been empowered to use any available state law or regulation to combat "off-exchange" fraud involving commodities. Second, state law enforcement in this area was enhanced by amendments to Section 8 of the Act, under which the Commission was expressly authorized to provide registration and other information to the states for law enforcement purposes, including information contained in otherwise confidential investigative files. And third, Section 6d(8) of the Act empowers state officials to proceed in state court against Commission registrants (except floor brokers or a registered futures association) for violations of any antifraud provision of the Act or any Commission antifraud rule, regulation or order.

In May 1984, the Commission's Division of Enforcement established a specialized unit to promote and foster cooperation and information sharing with the states as well as prosecution by the states, the Commission and other federal agencies of off-exchange and other illegal activity. This State/Federal Liaison Unit has compiled a central file which eventually will contain information on all known or suspected off-exchange commodity "boiler-room" operators in the United States. Since its inception, the Unit has shared information from its files with California, Colorado, Arizona, Michigan, New York, Ohio, Missouri, Texas, Virginia, Maine, Montana, North Carolina, Nevada, Georgia, Wyoming and Florida. The Unit also has prepared and coordinated the furnishing of expert legal and economic analyses to Illinois, New Mexico, Texas, and Wisconsin, and has shared information with the U.S. Postal Inspectors, the Federal Bureau of Investigation, the Internal Revenue Service, the Department of Justice fraud section, and numerous U.S. Attorney's offices.

One of the most vital functions served by the Unit is the investigation and prosecution of boiler-room operators through injunctive actions, both in conjunction with state officials and on its own. Since its inception, the Unit has filed 11 actions against illegal off-exchange boiler-rooms, six of which were joint actions brought with the states. In addition, the Unit has been involved in joint investigations with Arizona and Texas. Other units of the Division of Enforcement have filed joint actions with Arizona, Illinois and Texas against boiler-room operations.

CFTC relations with the states have been excellent since the passage of the amendments contained in the Futures Trading Act of 1982. The Commission has filed a total of 20 injunctive actions against off-exchange operations since the passage of those amendments. Twelve of the actions were joint, co-plaintiff actions with the states. Joint federal and state action and cooperation is truly making inroads on the nationwide problem of illegal commodity-related frauds.

In the interest of furthering federal/state cooperation, the Commission's Division of Enforcement recently held the Fourth Annual Enforcement Seminar in Washington, D.C., which was attended by officials from 24 states and Canada. A mid-winter enforcement seminar is being held in Portland, Oregon, February 18 and 19, and another seminar is scheduled for Los Angeles in March. That seminar will be presented to representatives of the Investment Fraud Task Force, which is comprised of state and federal law enforcement officials in Southern California.

The new cooperative spirit that exists between the states and the Commission is reflected also in the Model State Commodity Code, which the North American Securities Administrators Association (NASAA) adopted on April 5, 1985. The Code is designed as a modern "bucket shop" law to prohibit those commodity transactions which have been fraught with customer abuse. At the same time, the Code complements the Commodity Exchange Act by acknowledging legitimate commodity instruments regulated under federal law and by permitting the public to acquire commodities under specific terms of the Code.

The Code is the product of more than a year's effort by the NASAA Commodities Committee, with assistance from the staff of the Commission and the National Futures Association. The Commission has pledged to NASAA its assistance in having the Code introduced and passed in as many state legislatures as possible. Versions of the Code have already been enacted in New Mexico and Missouri and are actively being considered by several other states.

Another symbol of the efforts the CFTC and the sates have made in recent years is the ongoing work of the Commission's Advisory Committee on CFTC-State Cooperation. The Committee, which is comprised of federal and state law enforcement officials and representatives of the private sector, was created to discuss and offer advice on matters which concern both the states and the Commission under the Commodity Exchange Act. In November 1985 the Committee held its annual meeting in Washington to discuss CFTC-state enforcement issues and the CFTC state/federal liaison unit, criminal enforcement, the National Futures Association, and the North American Securities Administrators Association's Model Code.

F. Exclusion of Certain Persons from the Definition of Commodity Pool Operator

In connection with the adoption of the Futures Trading Act of 1982, the Senate Committee on Agriculture, Nutrition, and Forestry considered an amendment to the Commodity Exchange Act which would have exempted certain otherwise regulated entities from the definition of a commodity pool operator. In lieu of adopting such an amendment, the Committee urged the Commission to issue regulations which would have the effect of providing this relief. On April 23, 1985, the Commission adopted Rule 4.5, which excludes from the definition of a commodity pool operator, subject to certain conditions, banks and other financial depository institutions, trust companies, insurance companies, and numerous ERISA pension plans that use commodity interests in their management of cash portfolios. The Commission believes that the adoption of Rule 4.5 has addressed a major area of concern to these "otherwise regulated entities" and, as a result, has eliminated any major problems of duplicative regulation in this area.

G. Studies Mandated By Congress

In connection with the Commission's reauthorization in 1982, the Congress directed the Commission to study and report on four areas of Congressional concern. The Commission separately has forwarded to the Congress final reports on these studies. The purposes and conclusions of these studies are outlined below.

1. The Potential for Insider Trading in the Commodity Markets

One of the concerns Congress expressed during the 1982 reauthorization was the potential problem of individuals trading futures contracts based on material, nonpublic information. Congress asked the Commission to analyze this issue and the adequacy of the Commission's authority to prevent market and customer abuse as a result of trading on nonpublic information.

The Commission examined trading by (1) government employees who obtain information as a result of their employment; (2) employees of self-regulatory organizations, including their staffs and governing bodies, who obtain information as a result of their regulatory activities; (3) individuals who obtain nonpublic information as agents trading for their customers in the futures markets; and (4) others, including employees of firms who trade in the cash and futures markets.

The Commission determined that certain traditional notions concerning the legal requirements for establishing insider trading under the securities law are of limited application to the futures markets. The Commission concluded that provisions of existing commodities law adequately discourage government employees from using material, nonpublic information relevant to futures markets. With respect to employees and board members of futures self-regulatory organizations, the Commission noted that many such organizations have adopted a variety of restrictions against such trading.

In the interest of uniformity of regulation, the Commission has proposed rules that would make it a violation of CFTC regulations for employees of self-regulatory organizations to disclose material, nonpublic information obtained through their employment. The Commission has proposed, further, that selfregulatory organizations adopt rules to prohibit their employees from disclosing or trading on material, nonpublic information. In addition, the Commission's proposed rules would prohibit members of contract market or clearing organization governing boards or committees from trading in certain markets prior to the announcement of regulatory decisions by such bodies affecting those markets, and would bar them from disclosing information about the regulatory decisions. The Commission's proposed rules in this area are expected to be published in final form in the near future.

Among the possible types of customer and market abuses arising from insider trading in futures markets, historically there has existed particular concern about the potential harm of trading by floor brokers or other fiduciaries for their own accounts while having knowledge of the customer orders they are filling -- a practice known as "dual trading." While Commission and exchange rules require, among other things, that floor brokers execute customers' orders before trading for their own accounts, many exchanges have deficiencies in their trade reconstruction systems that have created difficulties in enforcing such rules in a timely and effective manner. To remedy this situation, and for other reasons, the Commission recently adopted new audit trail rules, which I will discuss later in my testimony.

The study focused also on the potential extent and effects of insider trading by directors, officers and employees of firms whose businesses involve the commodities underlying futures contracts, or by employees of firms issuing reports that may affect the market. The Commission is aware of the inherent problems in collecting information related to insider trading in futures markets by persons associated with cash market firms. However, on the basis of the findings in this study and because the study provides no significant evidence of such insider trading, the Commission is not recommending any legislative changes in this area.

The Commission will continue to watch for potential market abuses in this area and will be prepared to make any appropriate recommendations to the Congress in light of future Commission findings.

2. The Impact of Large Hedgers in the Livestock Futures Markets

The Congress in 1982 addressed its concerns about livestock futures markets by directing the Commission to conduct a two-year study of the manner in which large hedgers use the futures markets in live cattle, live hogs and pork bellies. These futures contracts are traded on the Chicago Mercantile Exchange. This study examined the activities of hedgers in livestock futures markets from October 1982 through June 1984.

Section 4a(3) of the Commodity Exchange Act requires the Commission to exempt bona fide hedging transactions from any position limit rules it adopts. Since hedgers are exempt from position limits, they have the potential of acquiring greater market power than individual speculators and a greater capacity to affect -- and possibly to distort -- futures prices. Analysis of position data confirmed, however, that although hedgers frequently held large livestock futures positions, no commercial traders accounted for an excessively large share of the open interest in an expiring livestock future during the last few days of trading. Nor did traders appear to use their hedge exemptions to affect deferred futures prices.

The study concluded that the existing regulatory programs of the Commission and the CME are adequate to deter any abusive trading by large hedgers in livestock markets and to preserve or restore orderly trading in those markets.

3. National Futures Association

Congress directed the Commission to submit a report on the regulatory performance of the National Futures Association by January 1, 1986. In its report the Commission concluded that NFA generally has succeeded in meeting its mandate under the Futures Trading Act of 1982 to adopt and, with certain exceptions, to implement a comprehensive self-regulatory program in the public interest.

By September 30, 1985, NFA had put into place a program reasonably designed to result in effective fulfillment of each of the specific objectives established by the Futures Trading Act of 1982. NFA has promulgated rules in each of the program areas specified in the 1982 legislation -- proficiency standards and testing; minimum capital, segregation, and other financial requirements; and sales practices -- and has also implemented effective arbitration, membership and disciplinary programs necessary to its continued registration under the Act. NFA has also initiated effective sales practice and financial audit programs for those of its members which are not also exchange members.

Certain aspects of NFA's self-regulatory program are not yet fully operational, however. In particular, as of September 30, 1985 (the end of the statutory evaluation period), a segregation audit program covering that portion of NFA's membership which also belongs to one of the commodity exchanges had only been in place for two months; similarly, while one exchange had voluntarily initiated a branch office sales practice examination program, NFA was only then concluding its agreements with four of the exchanges to conduct sales practice audits on NFA's behalf. Conclusions about the ultimate quality and effectiveness of these critical programs, therefore, cannot be drawn at this time.

In this connection, the Commission expects to continue to audit NFA's programs periodically as it does the programs of the contract markets. To facilitate this oversight process, the Commission is proposing statutory revisions to assure that its authority with respect to NFA is consistent with and at least as effective as its already-existing authority with respect to the designated commodity exchanges.

The impact on the Commission's operations as a result of the successful implementation of NFA's programs thus far has been material. Relieved of several resource-intensive functions and responsibility for most direct regulation, the Commission has been able to address its primary regulatory responsibilities in a more efficient and expeditious manner, to upgrade the quality of its oversight efforts, and to prepare for and react to innovation and substantial growth in the industry without a comparable expansion of its staff. This redirection of Commission energies has enhanced performance of the Commission's primary functions of oversight, market surveillance, enforcement, and policy development.

In measuring the cost savings attributable to the operations and activities of NFA, the Commission has endeavored to quantify the direct, tangible savings that resulted from the transfer to NFA of various functions, such as registration processing, which had formerly been performed by the Commission. The direct savings to the Commission that have thus far resulted from the implementation of NFA's regulatory program, representing actual Commission staff and other resources formerly dedicated to functions that have been transferred to NFA and which have now been redirected to other Commission priorities or eliminated, were estimated to total $3.5 million during the three-year period from Fiscal Year 1983 through Fiscal Year 1985.

During the same period, the Commission, the industry and the general public benefitted indirectly from a number of new activities undertaken by NFA, including NFA's initiatives in the areas of proficiency testing, registration of introducing brokers and their associated persons, and auditing and sales practice monitoring of introducing brokers, all of which were areas in which the Commission never established an operating program of its own.

Estimating the value of these benefits was a difficult aspect of the Congressional directive that the Commission estimate the projected cost savings to the Federal Government resulting from NFA's activities. The problem was that the budgets of the Commission and NFA cannot be compared directly. Factors such as federal limitations on compensation and travel expenditures, limitations on federal appropriations, differences in the experience levels and relative efficiency of the Commission and NFA staffs, and differences in start-up versus ongoing costs added to the difficulty. Nevertheless, the Commission estimates that

NFA's undertaking of these activities has enabled the Commission to avoid making additional appropriation requests over the last three fiscal years in order to fund these oversight activities, for which NFA expended $16.2 million.

In conclusion, the Commission has determined that NFA's various self-regulatory programs generally meet the minimum requirements established by the Congress and the Commission. These programs, however, are evolving, not static, and the Commission expects that they will be supplemented and become even more effective in the years ahead. The Commission therefore expects to continue to monitor NFA's further progress in order to ensure that NFA continues to perform adequately and properly implements the comprehensive program specified in the Act.

4. The Economic Effects of Futures and Options Trading

On December 31, 1984, the Commission, along with the Securities and Exchange Commission and the Federal Reserve Board, submitted to the Congress our report on a study of the economic impact of futures and options trading. The study was the joint effort of the three agencies with assistance from the Treasury Department.

The study concluded that the new financial futures and option markets serve a useful economic purpose, primarily by providing a means by which risks inherent in economic activity can be transferred from firms and other commercial entities less willing to bear them to those more willing and able to do so. As a result, these new derivative markets make it possible to fix the price at which an asset can be bought or sold in the future or the interest rate at which money can be borrowed or lent. This desirable risk transfer function appears likely to spread to additional commercial and financial firms and increase in magnitude as experience is gained with these new markets and legal impediments to their use are modified.

The study also concluded that financial futures and options markets appear to have no measurable negative influence on capital formation. Because options and futures markets do not absorb the real savings of society, these markets do not affect the total volume of funds available to financial markets. The new markets for financial futures and options appear to have enhanced liquidity in some of the underlying cash markets on which they are based and do not appear to have reduced the liquidity of any of these markets.

As a separate matter, the study concluded that trading in the functionally similar instruments under the jurisdiction of the SEC and CFTC has not harmed public customers or the derivative or related cash markets. The study reiterated both agencies' commitment to work cooperatively to establish a compatible framework of regulation to deal with activities requiring such supervision and regulation.

H. Introducing Brokers

Prior to 1982, the Act did not require the agents of futures commission merchants to be registered with the Commission in any capacity. Congress corrected this gap in 1982, however, and at the request of the industry created a new category of registrant, the introducing broker. Final rules governing the registration and regulation of introducing brokers and their associated persons were promulgated on August 3, 1983.

The major difficulty the Commission encountered in developing its rules in this area was the diversity of this class of registrant. For example, introducing brokers may be single-person offices, grain elevator operators, or securities broker-dealers who do not wish to establish a separate commodities business but prefer simply to refer business to a registered futures commission merchant. The Commission believes it has been successful in accommodating the interests of this diverse group in its regulations.

Capital requirements are an area where certain adjustments to the regulations were made to accommodate the variety of introducing broker applicants. In establishing the introducing broker category of registrant, Congress instructed the Commission that the minimum financial requirements for introducing brokers should "effectuate the Congressional purpose that introducing brokers have a sufficient reserve of capital to remain economically viable yet...not be so onerous as to constitute a barrier to the entry into, or continuation in, the commodities industry." Moreover, such financial requirements should "guarantee accountability and responsibile conduct of introducing brokers." In response, the Commission set the minimum net capital requirement at $20,000.

Nonetheless, the Commission found that many introducing brokers could not meet this requirement. As an alternative, therefore, Commission regulations permit an introducing broker to enter into a guarantee agreement with a futures commission merchant under which the futures commission merchant agrees to be jointly and severally liable for all obligations of the introducing broker under the Act and the Commission's rules, regulations and orders. The guarantee is intended to provide coverage for potential liabilities of the introducing broker arising from its business operations and customer relations.

The guarantee has become the primary means by which introducing brokers comply with the Commission's minimum financial requirements. In this connection, records maintained by NFA indicate that of the more than 900 introducing brokers, more than 700 are guaranteed by a futures commission merchant.

II. Ongoing CFTC Regulatory Initiatives

A. Audit Trail

The Commission recently adopted final rules designed to improve the trade-timing records of exchanges in order to achieve effective trade reconstruction. The rules require the actual execution time of each futures and option trade to be stated in one-minute increments on the trade register — the required exchange transaction journal. Notably, the actual time the trade is executed need not be recorded by the trader. The regulation does not specify the method for meeting this trade-timing standard, but permits each exchange to comply with the standard as it chooses. Thus, the Commission adopted a "performance standard," rather than a "design standard." For instance, an exchange could use manual recordation, a technology-assisted system, exchange-recorded times, order "exit" times, or a combination of these or other approaches, so long as the Commission's trade-timing standard is met.

As part of its oversight responsibilities, the Commission always has monitored exchange trade reconstruction capabilities to determine exchanges' abilities to enforce certain trading rules consistent with the Commodity Exchange Act and CFTC regulations. The new rules are an outgrowth of this ongoing review, particularly of the bracketing accuracy under the current requirement of 30-minute bracketing of trades, and of explicit Commission findings from its studies and investigations of certain markets and trading practices.

Specifically, in September 1984, the Commission's "insider trading" study concluded that 30-minute bracketing data is subject to inherent limitations in preventing or detecting and prosecuting trading abuses related to dual trading. These limitations made advisable rulemaking to require the exchanges to improve the speed and accuracy of reconstruction of trade sequences. The study also indicated that such rulemaking might consider permitting the exchanges to elect to bar dual trading in their markets.

Also in the fall of 1984, the Commission released a summary of its study of soybean futures trading on the CBT from August through December 1983. In the press release which accompanied this summary, the Commission emphasized the need for the commodity exchanges to develop detailed, accurate and automated audit trail systems to permit accurate analysis of intra-day trading patterns and their impact on intra-day price movements.

Prior to the completion of these studies, the Commission had requested a review of bracketing data as a result of exchange rule enforcement reviews in 1983. In particular, the Commission was concerned about the effective use of bracketing data under the self-regulatory requirements of the Act. The results of this review noted bracketing accuracy rates of approximately 70 percent at the larger exchanges and that certain exchanges did not appear to consider bracketing data particularly useful for conducting investigations. The issue of trade time recordation also was raised in January, 1984, when the Commission was asked to approve 30-minute bracketing rules for the New York Mercantile Exchange ("NYMEX"), which then had a pit slip system in which the time of the trade execution was recorded on the pit slip in one-minute increments. Despite Commission authorization of NYMEX's bracketing rules, NYMEX advised the Commission that it would continue to explore trade-timing alternatives and that it would not implement 30-minute bracketing. The NYMEX continues to use its pit slip system, even though it experienced a 36 percent growth in volume in 1984, and a 47 percent growth in 1985. Notably, two other exchanges, the Kansas City Board of Trade and the Minneapolis Grain Exchange, have one-minute manual timing systems. In addition, the Philadelphia Board of Trade and the Amex Commodities Corporation have one-minute trade-timing systems.

When the Commission proposed the amendments to audit trail reporting procedures, it noted some important benefits of the audit-trail improvements that could result from implementation of this rule. First, the more precise trade execution time standard should improve dramatically the surveillance capabilities and efficiency of both the exchanges and the Commission through improved detection of possible abuses. Trade reconstruction based on 30-minute bracketing, in many instances precludes, or makes difficult, determinations by investigators and by adjudicatory bodies whether a trading abuse or attempted manipulation has occurred. Second, the Commission noted that the new rules should have a deterrent effect as a result of the enhanced ability of the exchanges and the Commission to assure the integrity of the markets. A beneficial side effect also noted by the Commission may be increased confidence in the markets themselves.

Under the new rules, each exchange must determine and report to the Commission by July 1, 1986, the type of system it will adopt. The new rules require the exchanges to be fully operational by October 1, 1986, and using their enhanced audit trail data in their exchange compliance programs by January 1, 1987.

The Commission believes that, particularly in light of the lengthy rulemaking process, this schedule provides sufficient time for the implementation of improved systems.

B. Volume Investors -- A Regulatory View

In March 1985, Volume Investors Corporation, a clearing member FCM at the Commodity Exchange, Inc. (COMEX) and other exchanges, carrying accounts for approximately 100 public customers in regulated futures and option markets, defaulted on its obligations to the Comex clearinghouse. Three customers at Volume were holding uncovered short gold option positions totaling 12,000 contracts (representing 1.2 million ounces of gold) on March 18 and 19 when the price of gold experienced a sharp upward spike, rising $44 an ounce in two trading sessions and causing their positions to generate margin calls of over $26 million. These three customers defaulted on their margin calls to Volume, and Volume itself, a relatively small firm with net capital of only $2.5 million, was unable to absorb the loss. On Wednesday morning, March 20, the firm failed to meet its own margin obligations to the COMEX Clearing Association, which, nonetheless, continued to meet Volume's obligations to the other side of the market. Volume was left with about $10.1 million in assets to cover $13.7 million in obligations to customers, plus another $9.1 million in liabilities owed to exchange clearing organizations and $1.4 million owed to other FCMs, brokers, and general creditors.

CFTC staff was first informed of Volume's situation at about 9:30 a.m. on Wednesday, March 20, without any data on the firm's financial exposure. In order to obtain a clear assessment of the situation, auditors from the CFTC's New York regional office were directed to conduct an on-site investigation of the firm's books and records. When a deficiency of segregated funds to satisfy all of Volume's obligations to customers was found, the Commission acted to place the firm into judicial receivership, with the consent of Volume. Commission attorneys obtained the necessary legal order by consent from a U.S. District Judge at 8:30 a.m. on Thursday, March 21.

The Volume default prompted two immediate concerns for the Commission: first, that innocent non-defaulting Volume customers should not lose money as a result of the firm's demise, and second, to the extent that weaknesses in the regulatory structure contributed to the default, that these be corrected as quickly as possible. While the actual magnitude of customer equity frozen after the Volume default -- about $13.6 million -- was relatively small, another FCM failure could easily involve many times that amount.

Within days, Commission staff initiated an industry-wide review of regulatory safeguards for the financial integrity of industry firms and the protection of segregated customer funds. Based on the Commission's review of the incident, each designated exchange received a letter from the Commission outlining its recommendations for improved financial surveillance of the markets. In response, six exchanges, including COMEX, agreed during this period to amend their rules to establish minimum margin levels for out-of-the-money short option positions, and the COMEX Clearing Association also proposed to extend its system of capital-based position limits for futures positions to the option markets.

Having obtained a receiver for Volume, the Commission participated in the receivership proceeding, as requested by the court. In October, the receiver conducted an interim and partial distribution of approximately $7 million in Volume assets under which customers received approximately half of their mid-March account equity. In August, an agreement was reached under which Volume's principals, Owen Morrissey and Charles Federbush, would contribute $4.1 million to cover the firm's obligations, which with remaining Volume assets of about $2.5 million would make a full customer reimbursement possible. This agreement dissolved in November, however, when Mr. Morrissey withdrew from the plan after certain customer releases called for in the agreement were not forthcoming. Most recently, in December, COMEX and Mr. Federbush agreed to provide Volume $4.1 million to complete the customer distribution, and an agreement was reached, subject to court approval, with two of the original defaulting Volume customers to pay $5 million in settlement of their original liabilities.

Based on its continuing investigation of the affair, the Commission's Division of Enforcement filed an administrative complaint on August 27 against COMEX, the COMEX Clearing Association, Volume Investors, and various individuals, alleging violations of the Act and applicable regulations in connection with the default.

On July 29, the CFTC Division of Trading and Markets reported to the Commission on its examination of the Volume default. The principal recommendation of the report was that the Commission adopt regulations correlating the market exposure which any firm is permitted to carry to the amount of a firm's net capital.

The Volume Investors situation demonstrated that if a customer default causes a default which is so severe that an FCM cannot cover the deficit from its own funds, the non-defaulting customers of that FCM will have their funds tied up pending litigation of the firm's claim against the defaulting customer, unless money to cover that deficit can be found elsewhere. As it is the financial integrity of a firm that stands behind customer funds, FCMs are required to meet a minimum net capital standard. The Commission now believes that capital level should more precisely reflect the risk of positions carried by the firm. The comment period on proposed new capital rules that address this issue has been extended to March 5.

In its July 1985 report on Volume Investors, the Commission's Division of Trading and Markets also proposed that the Commission articulate its standards for reviewing exchanges' margin rule systems to provide that (1) option purchasers must pay the full premium price at the time of purchase and not receive gains until the position is liquidated, (2) for short options, the required margin must be a reasonable amount in addition to the premium received on the option sale and, for covered positions, the cover must be in the possession or control of the FCM carrying the position, and (3) for exchange members, advantageous margin rules may be permitted to encourage liquidity or other desirable market effects, but only so long as they meet minimum standards. This margin guideline was published for comment August 5, 1985. Several commenters suggested that final action on the proposed guideline be addressed concurrently with action on a rule to permit application of futures-style margining to options, as proposed by the Commission on March 9, 1984. Currently, industry representatives are working to develop a consensus view on the futures-style margining issue.

To remedy certain weaknesses in exchange financial surveillance systems, the staff in July 1985 also issued a significant revision to its Financial and Segregation Interpretation 4, which governs how exchanges and clearing organizations oversee member compliance with minimum financial, segregation, and other requirements. The revised interpretation, among other things, requires that open positions at member FCMs are monitored on a daily basis to assess the potential impact of possible price movements on the financial integrity of the firm. This interpretation is now being implemented at each designated exchange, and Commission staff is monitoring compliance with the new standards.

Commission staff also suggested that the Commission request the National Futures Association to examine the possible role of customer account insurance as a safety net to protect customers in regulated futures and option markets against losses due to failures by industry firms, and an NFA study on the matter is currently underway.

C. Option Pilot Program

On November 3, 1981, the Commission published final rules establishing a strictly controlled, three-year pilot program to permit exchange-traded commodity options. Initially, the pilot program permitted each exchange to trade one option on a commodity futures contract on other than domestic agricultural commodities. In September 1982 the Commission designated the first options under the pilot program -- options on sugar, gold and Treasury bond futures.

The Commission has monitored trading closely in the originally designated options, and based upon the absence of significant customer or other abuses, has expanded the pilot program so that at the present each exchange may trade up to eight options, including up to two options on physical commodities. Currently, sixteen options have been designated to trade under the pilot program, including in addition to those initially approved, options on stock indexes, silver, Treasurynotes, Eurodollars, foreign currency and cocoa futures contracts, and options on gold and Eurodollar physicals.

Following the 1982 repeal by Congress of the 1936 statutory ban on options involving domestic agricultural commodities, a separate three-year pilot program for the trading of options on those commodities was adopted on January 23, 1984. Under this pilot program, each exchange could be designated for two options on domestic agricultural futures contracts and the first contracts began trading in October 1984. Currently, ten options, including the grains, livestock, cotton and frozen concentrated orange juice, are trading under this pilot program, and the Commission is considering whether a further expansion of this program is warranted.

The Commission's pilot program for exchange-traded options has resulted in a phased expansion of commodity option trading in the United States. By permitting phased expansion only after obtaining increasing experience in trading, the Commission has assured itself that the public would be protected from the types of abuses which previously plagued the off-exchange offer and sale of such options. Now that the initial three-year test period has concluded, the Commission is evaluating the overall experience of trading under the pilot program and will be determining whether different or additional rules are appropriate.

D. Internationalization of the Markets -- Regulatory Implications

Increasingly, the commodity markets are assuming a growing international dimension and the Commission is playing a vital role in accommodating this expansion through appropriate regulatory changes and proper oversight. In August 1984, the Commission approved contract market rules establishing one international link -- the "mutual offset system" developed by the Chicago Mercantile Exchange and the Singapore International Monetary Exchange, Ltd. Currently, the Commission is reviewing proposed rules which would establish the second such link, in this case between the Commodity Exchange, Inc. and the Sydney Futures Exchange, Ltd.

Because the CME-SIMEX arrangement was the first of its kind involving a U.S. exchange, the Commission was in uncharted waters as it proceeded to analyze the issues presented by such a novel and complex arrangement. The Commission's review of that proposal endeavored to ensure that the planned linkage would not adversely affect the integrity of the domestic market. As a consequence, the Commission carefully analyzed every facet of the proposal, including: the financial safeguards for the CME, its clearing members and their customers; the large trader reporting, speculative position limit, and contract delivery provisions; the protections and remedies available to domestic users of such a linkage; and the effects of foreign and international law, especially with respect to the Commission's ability to obtain potentially significant market surveillance information.

In the interest of assuring access to market surveillance data, the Commission has formed a cooperative arrangement with the Monetary Authority of Singapore and is developing working relationships with its counterpart agencies in more than a dozen foreign countries. As a result, the Commission has gained invaluable experience in analyzing and commenting upon new developments in the international arena, including the regulatory and self-regulatory systems now being developed in Great Britain and Australia.

III. 1986 Reauthorization: The CFTC Proposal

A. Enforcement; Appellate Review

1. Section 4b Prohibition of Fraud in All Futures Contracts

One of the Commission's proposed amendments would alter Section 4b of the Act, which generally prohibits any person from cheating or defrauding any other person "in or in connection with any order to make, or the making of, any contract of sale of a commodity for future delivery, made, or to be made, on or subject to the rules of any contract market...." [Emphasis added.] Our proposed amendment would delete the underlined language, making the antifraud provision of Section 4b expressly applicable to any commodity futures transaction, regardless of whether executed on or subject to the rules of a contract market.

Several courts have entered injunctions against further violations of Section 4b in cases brought by the Commission involving the off-exchange sale of futures contracts. Nonetheless, the Commission is concerned that the language of Section 4b might be interpreted narrowly to limit its authority to exchange-traded futures, resulting in a court's refusal to apply Section 4b to the sale of off-exchange futures contracts. The proposed amendment would simply codify the Commission's interpretation of Section 4b and make it consistent with other antifraud provisions of the Act and Commission rules, which are not limited to transactions conducted on a contract market.

The amendment would not expand the Commission's jurisdiction. As noted in the 1982 reauthorization process, the Commission strongly encourages individual states to play an active role in stopping off-exchange fraud operations doing business in their state. This amendment would simply make it clear that both the

Commission and the states have the authority to prosecute fraud committed by off-exchange operators.

2. Extraterritorial Service of Subpoenas

The Commission proposes to amend Section 6(b) of the Commodity Exchange Act specifically to authorize the Commission to serve investigatory and other administrative subpoenas on persons outside the territorial United States. We believe the proposed change is necessary because in a recent decision the U.S. Court of Appeals for the District of Columbia Circuit ruled that Section 6(b), as presently drafted, does not authorize enforcement of an investigatory subpoena served on a foreign citizen in a foreign country.

In the course of its investigation of events in the U.S. silver market during 1979 and 1980, the Commission had cause to believe that one of the principal participants in the market was Naji Robert Nahas, a dual citizen of Brazil and Lebanon, then residing in Brazil. In 1983 the Commission issued a subpoena directing Nahas to appear with his records of relevant transactions at the Commission's offices in Washington. The subpoena was served upon Nahas in Sao Paulo. The Commission had retained a Brazilian attorney to serve the subpoena at the suggestion of the U.S. Department of State. When Nahas failed to respond to the subpoena, the Commission filed suit in the U.S. District Court for the District of Columbia to enforce the subpoena. When Nahas failed to comply with the court's order enforcing the subpoena, the court found Nahas in contempt. However, the U.S. Court of Appeals for the District of Columbia later overturned the district court's decision, holding that Section 6(b) of the Act did not authorize enforcement of an investigatory subpoena served on a foreign citizen in a foreign country. The appeals court did not question the authority of Congress to so authorize the Commission, but rather ruled that Congress had not granted such authority when it enacted Section 6(b).

If allowed to stand, the Court of Appeals' ruling may foreclose the Commission from investigating the conduct of foreign market participants, regardless of the magnitude of their involvement in U.S. markets, so long as they, or other witnesses, remain outside the territorial United States. Under this ruling, even though a foreign participant's conduct is clearly subject to the requirements of the CEA, and despite the existence of sufficient contacts with the United States to establish *in personam* jurisdiction as a matter of due process, the foreign participant may only be subject to the Commission's subpoena power if service can be made in the territorial United States. The Commission does not believe Congress intended this result.

3. Review of CFTC Orders in Courts of Appeal

Some types of final Commission orders are, pursuant to specific sections of the Act, subject to judicial review only in the United States Courts of Appeal. Other types of final Commission orders, about which the Act is silent on the forum for judicial review, are governed by the provisions of the Administrative Procedure Act. Under the APA, judicial review typically begins in the U.S. District Courts. One of the amendments to the Act proposed by the Commission would add a new section to the Act providing that persons aggrieved by a final Commission order or rule may obtain review of that order or rule only in the United States Courts of Appeal.

In the course of issuing many of its final orders and rules, the Commission employs a number of administrative procedures that, in many ways, are analogous to the function of the district court in gathering and weighing evidence in disputed matters. In its rulemaking function the Commission also reviews the facts developed through the comment process before adopting its final rules. And in reviewing the actions of self-regulatory organizations, the Commission reviews the facts developed in the organization's proceeding. In each of these situations the Commission develops or reviews an adjudicatory or administrative record before issuing its rule or order. If a person believed that the Commission acted without authority or erred in its decisionmaking, the Commission's proposed amendment would eliminate the need for review in the district court. Review by a court of appeals, which simply reviews the complete record and does not attempt to reconstruct or supplement evidence used in the Commission's decisionmaking, would provide for a definitive ruling more promptly and save judicial and Commission resources, as well as the resources of the aggrieved party.

The idea of consolidating in the Courts of Appeal the judicial review of all rules or orders issued under a statute is not novel. For example, several statutes enforced by the Securities and Exchange Commission all contain a provision that provides for judicial review solely by the U.S. Courts of Appeal. Further, the trend in courts' interpretation of judicial review provisions is to encourage plaintiffs to take their grievances through the administrative appeal procedures directly to a court of appeals, rather than through both administrative appeal and a district court proceeding before going to the court of appeals.

4. Statutory Authority to Obtain Ex Parte Appointment of Receiver

Section 6c of the Commodity Exchange Act authorizes the Commission on an *ex parte* basis to obtain a restraining order to freeze the assets of persons it believes have engaged in or are about to engage in a violation of the Act or Commission rules, and to prevent such persons from destroying books and records. As the section is presently written, there is no express power for the court to appoint a receiver on an *ex parte* basis to protect and manage the business of the entity subject to the freeze order. The Commission proposes to amend Section 6c to authorize the *ex parte* appointment of a temporary receiver pending a hearing to decide whether a permanent receiver should be appointed or such other hearing as the court may order.

In many instances in which the Commission takes enforcement action against an off-exchange operation, the Commission will seek to obtain an *ex parte* restraining order to protect books and records and to freeze the operation's assets, but no independent person is in place to ensure that the books and records and assets are protected, and in some cases, to preserve assets by making day-to-day business decisions until a permanent receiver can be appointed. In at least one case, it is suggested that a defendant disposed of books and records and transferred the assets of a defendant after an *ex parte* order was issued.

Often, the period between issuance of the *ex parte* restraining order and the hearing on the application for appointment of a receiver can be as long as 15 to 20 days. During that time, the restrained operation may hold open positions in the futures market that would go unmanaged or be liquidated for failure to meet a margin call. In addition, while assets are frozen, employee salaries may go unpaid and employees may quit, further limiting the ability of the operation to preserve any assets it may have. A temporary receiver could pay salaries and other legitimate expenditures, meet margin calls or liquidate unprofitable positions, and otherwise protect the assets of the operation for ultimate distribution to customers.

B. Leverage Transactions

Another proposal in our legislative package would amend the Commodity Exchange Act to exclude entirely leverage transactions from regulation under the Act. Under this amendment the Commission would neither be required nor authorized to regulate leverage transactions as a distinct form of commodity instrument.

In order to place this proposal in perspective, it may be helpful to consider briefly the history of leverage and its regulation. In the Commodity Futures Trading Commission Act of 1974, the Commission was first given exclusive regulatory jurisdiction over gold and silver leverage transactions. In 1978 Congress banned leverage transactions in agricultural commodities and extended the Commission's exclusive leverage jurisdiction to all other commodities, in addition to gold and silver. Between 1974 and 1982, the Commission adopted three regulatory measures for leverage transactions: two temporary moratoria on the entry of persons into leverage businesses involving gold and silver bullion or coins or other commodities, and an anti-fraud rule.

With the enactment of the Futures Trading Act of 1982, Congress significantly amended the Commission's authority to regulate leverage contracts. Previously, the Commodity Exchange Act required that any leverage transaction determined by the Commission to be a contract for future delivery within the meaning of the Act be regulated as such. The 1982 Act, however, repealed this provision. In its place, Congress enacted a new Section 19(c) specifically to require the Commission to regulate leverage transactions in gold or silver bullion or bulk coins or in any other commodities, except those subject to the 1978 prohibition on agricultural leverage transactions. New Section 19(c) also vested in the Commission the authority to prohibit any leverage transaction for the delivery of any commodity that was not permitted by the rules, regulations and orders of the Commission in effect on December 9, 1982, if the Commission determines that such transactions would be contrary to the public interest.

As a result of the direction given by Congress in 1982, the Commission in 1984 and 1985 issued interim final leverage regulations for long and short leverage transactions in gold and silver bullion and coins, copper, platinum and certain foreign currencies. The development and administration of this program has been both time consuming and labor intensive, involving direct regulation of the operations of individual firms.

Following its experience with leverage regulation, and in view of current constraints, the Commission now requests amendments that would eliminate federal leverage regulation, and would remove from the Act virtually all references to leverage transactions. The amendments would eliminate what the Commission perceives as the historical and unjustified statutory distinction between leverage and futures contracts. In the Commission's View, leverage transactions are legally and economically indistinguishable from futures contracts and therefore do not warrant separate statutory treatment.

Under the proposed amendment, the Commission would remain authorized to bring law enforcement proceedings against those firms marketing off-exchange futures contracts, including leverage contracts, and the states, in addition to initiating or participating with the Commission in such enforcement proceedings, could enact and enforce legislation prohibiting the marketing of those contracts. However, if the proposal is enacted, the Commission believes that those firms which the Commission has registered as leverage transaction merchants under its existing regulations should be afforded a sufficient period of time to modify their business to remain in full compliance with the law. To this end, language could be included in the Committee reports accompanying the legislation expressing the intent of Congress that the Commission refrain from taking any enforcement action against such firms based solely on their continued offer or sale of leverage contracts or servicing of existing accounts during the period from enactment of the bill until, for example, January 1, 1988.

In this connection, the Commission points out that the amendment would not necessarily terminate the business of these firms. Specifically, it may be possible that the current leverage firms could, albeit with some modifications to their operations, continue in business by undertaking the marketing of cash and/or installment sale transactions. While this business would be subject to any existing state regulation, such cash and installment transactions would be permissible even in states that had adopted the North American Securities Administrators Association Model State Commodity Code.

In general, the Model Code is designed as a modern bucket shop law to prohibit the types of off-exchange commodity transactions which have been fraught with customer abuses. Nevertheless, the Code does permit the marketing of any commodity contract for the purchase of precious metals which requires, and under which the purchaser receives, within seven calendar days from the payment of any portion of the purchase price, physical delivery of the quantity of precious metals purchased by the payment. In this regard, physical delivery is deemed to have occurred if, within the seven-day period, the precious metals purchased are delivered to a financial institution or other specified entity other than the seller. In addition, the Model Code permits the offer and sale of any contract under which the purchaser receives, within 28 calendar days from the payment of any portion of the purchase price, physical delivery of the total amount of the commodity to be purchased under the contract.

In the process of formulating its legislative proposal on leverage, the Commission also considered two alternatives to eliminating leverage transactions from regulation under the Act: retaining, and perhaps codifying, the existing moratoria; and lifting the moratoria, provided NFA or another registered futures association would share responsibility for regulating and policing an expanded leverage industry.

No Commissioner favored the alternative of retaining the existing statutory and regulatory scheme. However, should the Congress wish to do so, the Commission would respectfully request that the Congress, whether by statutory enactment or report language, support the Commission's existing moratoria provisions.

Two Commissioners favored an alternative plan under which the moratoria could be lifted gradually, provided the NFA or another registered futures association would share with the Commission the responsibility for regulating and policing an expanded leverage industry. However, before any modification of the moratoria could be made, substantial study of the impact upon any resource implications for both the Commission and NFA would need to occur.

In summary, because the Commission is concerned with the expansion of off-exchange instruments and the required commitment of resources which could otherwise be dedicated to overseeing the futures industry, the Commission recommends that leverage regulation be deleted from the Commodity Exchange Act. In any event, the Commission assures the Committee that these alternatives were thoroughly discussed and that the Commission will fully cooperate with whatever the Congress should decide on this matter.

C. Registered Futures Associations

1. Disciplinary Actions

The National Futures Association's disciplinary system for violations of its rules by members or their associated persons includes a summary procedure called a "member responsibility action" (MRA) which is used by NFA to obtain expeditious compliance with its rules and provide immediate protection to customers. The Commission generally regards the MRA as a powerful and appropriate tool for self-regulatory bodies such as the NFA to obtain immediate compliance. However, an impediment to the effective use of the MRA procedure -- and to NFA's disciplinary program as a whole -- results from the provisions of Section 17(h) of the Commodity Exchange Act.

Specifically, Section 17(h) presently provides that any person who is the subject of an NFA disciplinary action may appeal that action to the Commission with the effect of automatically staying the effectiveness of the NFA action. The Commission can lift the stay, but only after providing notice and opportunity for a hearing, which may consist of affidavits and oral argument. As a result, the effectiveness of NFA's MRA procedure -- which, by its very nature, is designed for use where immediate action is necessry to protect the markets, customers or other NFA members -- can be dramatically reduced. Similarly, the effectiveness of any sanctions imposed as a result of formal NFA disciplinary procedures are likely to be diminished if a suspended or expelled member can forestall the result merely by filing an appeal with the Commission.

The Commission, therefore, proposes to amend Section 17(h) to make the automatic stay provisions of that section inapplicable to NFA disciplinary actions, including member responsibility actions. This amendment would make the stay provisions of NFA's member responsibility actions parallel those for exchange disciplinary actions.

2. Commission Review of Association Action

Under the Commission's proposal, Section 17(h) and 17(i) would be amended to make explicit that Commission review of NFA disciplinary actions is available only for final actions, precluding the disruption of the NFA disciplinary process by untimely appeals to the Commission, and ultimately, the courts. Further, we propose to amend Section 17(i) expressly to authorize the Commission to review only the record before NFA and the submissions of the parties. The actual standards for Commission review of any NFA decision would, however, remain essentially unchanged.

Finally, we propose to amend Section 17(i)(3), which deals with denial of membership in NFA or to association with an NFA member, to make the standards for Commission review of an NFA decision similar to those governing NFA disciplinary actions.

3. Rule Review Procedures

In order to facilitate the Commission's continuing oversight program of the National Futures Association and that group's implementation of key self-regulatory functions, the Commission is proposing legislative amendments designed to ensure that the

Commission's oversight powers under the Act with respect to NFA parallel those for contract markets, the other self-regulatory organizations under the Commission's jurisdiction. Under the current law, the Commission's authority to alter or supplement the rules of the exchanges is significantly broader than its authority to change NFA rules.

Section 8a(7) of the Act permits the Commission to alter or supplement rules of the contract markets where such changes are "necessary or appropriate for the protection of persons producing, handling, processing, or consuming any commodity traded for future delivery on [a] contract market...or for the protection of traders or to insure fair dealing in commodities traded for future delivery on such contract market."

In contrast, Section 17(k)(2) authorizes Commission alteration and supplementation of NFA rules only where "necessary or appropriate in the public interest or to effectuate the purposes of this section [authorizing the establishment of registered futures organizations such as NFA]" with respect to three specified, largely procedural areas:

> (A) the basis for, and procedure in connection with, the denial of membership or the barring from being associated with a member or the disciplining of members or persons associated with members, or the qualifications required for members or natural persons associated with members or any class thereof;
>
> (B) the method of adoption of any change in or addition to the rules of the association; [and]
>
> (C) the method of choosing officers and directors.

The difference in standards between the Commission's authority with respect to rules of NFA and the exchanges results in several anomalies. For instance, while the Commission is authorized to require alteration in an exchange's rules on minimum financial requirements for member futures commission merchants, the Commission apparently is not authorized to require such changes to be made in identical rules promulgated by NFA. Current statutory language also appears to exclude Commission alteration of NFA rules governing sales practices, despite the fact that NFA has primary responsibility for this area and is required by the Act to establish and implement a comprehensive sales practice program.

The Commission therefore proposes to amend Section 17(k) to make the Commission's authority to alter or supplement NFA rules parallel to, and no less broad than, the Commission's comparable authority with respect to the self-regulatory activities of the contract markets.

A similar, though less troubling, disparity is found in the statutory procedures concerning the Commission's authority to review and approve or disapprove new rules proposed by NFA and exchanges. While Section 17(j) of the Act requires that the Commission act on NFA rule proposals within 30 days unless a longer period is requested by either NFA or the Commission, no such limitation exists in Section 5a(12), which establishes rule review procedures with respect to the exchanges. In practice, the 30-day provision in Section 17(j) has not had a tangible impact on Commission review of NFA rules, and the difference appears to be purely technical.

A similar 30-day requirement formerly applied to the Commission's review of exchange rules under Section 5a(12) but was repealed in 1982 when Sections 5a(12) and 17(j) were substantially amended to establish the current, more streamlined rule review procedure. The legislative history of those amendments does not indicate any reasons why the otherwise parallel rule review procedures should differ in this relatively insignificant respect. The Commission therefore proposes that the NFA rule review process be made consistent with the similar provision governing other self-regulatory organizations.

D. Miscellaneous Amendments

1. Certain Prohibited Transactions

Section 9(d) of the Commodity Exchange Act makes it a felony for a Commissioner or Commission employee to participate, directly or indirectly, in commodity futures, option or leverage transactions or, with certain limited exceptions, in investment transactions in an actual commodity. In view of the vast increase in types of commodities on which futures contracts are now traded, the Commission is proposing changes to Section 9(d) to ease some of these restrictions. The amendments are designed to enable the Commission to administer Section 9(d) flexibly to assure that transactions that do not pose any conflict of interest concerns are not subject to the broad prohibitions contained in the present law. The proposed amendments should also obviate the need for the Commission to seek additional amendments to Section 9(d) in the future, as the commodity markets continue to expand into new areas.

Our proposed change to Section 9(d) would limit the restrictions on investment transactions in actual commodities to cover only those transactions which involve the use of nonpublic information or which are affected by means of a Commission-regulated instrument, such as a commodity futures or commodity option contract. Investment transactions in actual commodities permitted under existing law would continue to be permitted under the proposed amendments.

This proposal is consistent with Congressional revisions enacted in 1982. At that time Congress amended Section 9(d) to permit Commissioners and employees to invest in U.S. Government securities, certificates of deposit or similar financial instruments, so long as no nonpublic information is used and the transaction is not affected by an instrument regulated by the Commission. In the Commission's view, there is no reason why the philosophy underlying this 1982 amendment should not apply to investments in other commodities. So long as nonpublic information is not used and the commodity options or futures markets are not employed, the Commission believes the conflict of interest concerns underlying Section 9(d) are greatly diminished and its employees should be free to invest in actual commodities. Our proposal generally would permit these types of investments.

However, our proposal would prohibit investment transactions in actual commodities or instruments under other regulatory authorities that are specified by Commission rule. The Commission believes this provision is necessary in order for the Commission to adopt rules to avoid the appearance of conflicts of interest in certain instances. For example, various stock indexes are the subject of both futures contracts and options on futures contracts. Investment in these indexes would still be prohibited if effected through commodity futures and options contracts, since these are instruments regulated by the Commission. Some of these indexes, however, also underlie options traded on national securities exchanges. The Commission questions whether it would be appropriate to permit its employees to acquire an interest in these stock indexes by use of instruments which resemble Commission-related options.

The second change we propose would empower the Commission to develop appropriate exceptions to the absolute restrictions against participation in futures and options transactions. These exceptions, such as to permit modest holdings in large mutual funds that hedge their portfolios in the futures market, would be made only when the Commission determined that such investments would pose no conflict of interest concerns and otherwise would be consistent with Congressional intent in enacting Section 9(d). Of course, notwithstanding the adoption of any such exceptions that would permit Commission personnel to engage in such transactions, all Commissioners and employees would continue to remain subject to the criminal provisions of Section 9(e) of the Act, which bar Commissioners and employees from divulging to any market participant confidential information that may affect market prices.

2. Six-Year Reauthorization

Section 12(d) of the Commodity Exchange Act authorizes the appropriations of such sums as are required to carry out the provisions of the Act through the fiscal year ending September 30, 1986. We propose to extend the authorization for such appropriations for six years, until the fiscal year ending September 30, 1992.

The Commission has been fortunate to have the active interest and on-going oversight of this Congressional Committee. We welcome your continued direction and oversight until our next reauthorization.

EXPLANATION OF H.R. ________

TITLE I - ENFORCEMENT; APPELLATE REVIEW

Fraudulent Practices

Section 101 of the bill would amend the Commodity Exchange Act to make explicit that the proscription against fraud and other abusive practices in Section 4b applies to the offer or sale of all commodity futures contracts and therefore that persons may be held liable for fraud under Section 4b in connection with the marketing of illegal, off-exchange futures contracts in violation of Section 4(a) of the Act.

Section 4b of the Act generally proscribes fraud and other abusive practices in connection with commodity futures contracts made, or to be made, "on or subject to the rules of any contract market". By this section, Congress has specifically sought to protect customers from fraudulent activity in connection with futures transactions. However, the language in Section 4b quoted above could be misinterpreted as limiting these protections only to those customers who are defrauded in connection with the purchase or sale of futures contracts traded on Commission-designated contract markets. Such a misinterpretation could result in the anomalous situation where purveyors of illegal, off-exchange futures contracts who also commit fraud could not be charged under Section 4b. In addition, such persons would be immune from conviction under Section 9(b) of the Act, which makes it a felony knowingly to violate Section 4b. Section 101 would eliminate the "on or subject to" phrase from the law so as to assure that the courts interpret Section 4b consistent with Congressional intent.

The history of the Commodity Exchange Act is totally consistent with this clarifying proposal. That history reflects an ever-increasing Congressional concern that the public be protected from fraudulent and other unlawful activities and that there be appropriate law enforcement tools available to vindicate those public interests. In 1921, Congress first declared that futures trading in grains could lawfully occur only on federally-designated commodity exchanges. In 1936, Congress expanded the list of federally-regulated commodities, and at the same time, enacted Section 4b of the Commodity Exchange Act to outlaw fraud and other abuses in connection with commodity futures trading. As enacted in 1936, Section 4b governed only the conduct of commodity exchange members, but in 1968 Congress broadened the scope of Section 4b to cover fraud committed by "any person" acting for another in connection with commodity futures trading.

In 1974, Congress again amended the Act to expand its coverage to futures trading in virtually all commodities and to create the Commission to administer and enforce the Act. The Commission was given broad enforcement authority both to enjoin and to prosecute fraudulent conduct. As part of the 1974 amendments, Congress also established a Commission reparations program by which customers could prosecute claims for damages arising out of violations of the Act, such as Section 4b. Congress' actions in 1974 also preserved customers' existing rights to seek damages in court for violations of Section 4b. In 1978, Congress again amended the Act, this time to give the states power to enjoin violations of Section 4b, as well as other provisions of the Act, in federal district court, and to seek money damages for their citizens for these violations.

Finally, in 1982, Congress reconfirmed that all futures trading must take place on designated exchanges by recodifying existing provisions of the Act into Section 4(a). In 1982 Congress also empowered the states to proceed in state court against CFTC registrants who violate Section 4b and the other anti-fraud provisions of the Act and the Commission's regulations.

These other anti-fraud provisions contain no limiting language to suggest that they apply only to fraud committed in connection with otherwise lawful contracts. For example, Section 4o of the Act makes it unlawful for a commodity trading advisor or commodity pool operator to defraud any client or participant or to engage in any transaction, practice or course of business which operates as a fraud or deceit. Similarly, Commission regulations proscribing fraud in connection with foreign futures contracts, leverage transactions, and commodity options contain no such limiting language as that contained in Section 4b of the Act. *See* 17 C.F.R. §§ 30.02, 31.3, 32.9 and 33.10.

Moreover, the Commission has never interpreted Section 4b so as to limit its application to exchange-traded futures contracts. Instead, the Commission has repeatedly alleged fraudulent activity in violation of Section 4b in injunctive actions involving the illegal, off-exchange sale of commodity futures contracts and the courts have entered injunctions against further violations of Section 4b in these cases.[1] Nevertheless, a court could read the provisions of Section 4b narrowly, and deny its application to off-exchange operators. In two recent decisions in private litigation, federal district courts held Section 4b inapplicable to foreign futures contracts because these contracts were not sold on or subject to the rules of a United States contract market.[2]

As the Commission has stated, the requirement that a futures contract be executed on a designated contract market is what makes the contract legal, not what makes it a futures contract. *In re Stovall*, Comm. Fut. L. Rep. (CCH) ¶20,941 (CFTC 1979). Indeed, because the sale of off-exchange futures contracts has been declared both by the Congress and the Commission as illegal *per se*, such activity should be viewed in and of itself as perpetuating a fraud upon the public. Congress should act now to amend Section 4b to clarify that purveyors of off-exchange futures contracts may not defend fraudulent conduct on the basis of a narrow reading of Section 4b. The Commission, the states and public customers should be able, in actions brought under the Commodity Exchange Act, to proffer evidence of fraudulent conduct against these purveyors of off-exchange futures contracts so that Congressional intent can be fully effectuated against an activity which has been unlawful since 1921.

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[1] *See, e.g., CFTC v. FITC*, C.A. No. 85-1555 (N.D. Cal.) (preliminary injunction June 6, 1985); *CFTC v. National Monetary Corp.*, No. 85-72570 (E.D. Mich.) (preliminary injunction July 22, 1985); *CFTC v. International Silver Bullion*, No. 84 C 10501 (N.D. Ill.) (temporary restraining order January 11, 1985). In each of these cases, the Commission charged the unlawful sale of off-exchange futures contracts as well as violations of Section 4b. However, the courts did not analyze the language of Section 4b in these cases.

[2] *See deAtucha v. Comex*, Comm. Fut. L. Rep. (CCH) ¶22,580 (S.D.N.Y. 1985); and *Kleinberg v. Bear Stearns & Co.*, Comm. Fut. L. Rep. (CCH) ¶ 22,613 (S.D.N.Y. 1985). *Cf. Palmer Trading Co., Inc. v. Shearson Hayden Stone, Inc.*, Comm. Fut. L. Rep. (CCH) ¶20,900 (S.D.N.Y. 1979) (Section 4b held not to apply to London commodity options).

Extraterritorial Service of Subpoenas

Section 102 of the bill would amend Section 6(b) of the Commodity Exchange Act expressly to empower the Commission to serve administrative subpoenas on persons located outside the United States in order to assure the attendance of such persons in connection with Commission investigations and administrative proceedings conducted in this country, including those commenced by the service of complaints abroad. The amendment would also apply to subpoenas for the production in the United States of books and records and other documents located abroad. Section 102 would thus provide the explicit legislative authority in Section 6(b) which the Court of Appeals for the District of Columbia found lacking in CFTC v. Nahas, 738 F.2d 487 (D.C. Cir. 1984).

The Nahas case arose from the judicial enforcement of a Commission subpoena issued as part of the investigation of the events in the silver markets between 1979 and 1980. Nahas, a dual citizen of Lebanon and Brazil, was served with a subpoena in Brazil directing him to give testimony and to produce documents concerning his involvement in the United States silver markets. When Nahas failed to respond to the subpoena, the Commission instituted proceedings to enforce the subpoena in the United States District Court. Those proceedings resulted in an adjudication of contempt when Nahas failed to comply with the court's order enforcing the subpoena. CFTC v. Nahas, [1982-84] Comm. Fut. L. Rep. (CCH), ¶ 21,940 (D.D.C. 1983).

However, the Court of Appeals vacated the orders of the District Court. The Appeals Court held that section 6(b) of the Act does not authorize the enforcement of an investigatory subpoena served on a foreign citizen in a foreign country. The Court also found that the legislative history of section 6(b) "does not indicate that Congress intended to clothe the Commission with the power to serve investigatory subpoenas extraterritorially." 738 F.2d at 493. The Court emphasized, however, that its ruling "does not pose a question about the authority of Congress; rather it poses a question about the congressional intent embodied in [Section 6(b)]." 738 F.2d at 495. Indeed, the Court specifically invited the Commission to seek congressional clarification of its investigatory powers. Id. at n.17.[1/]

The Commission has consistently viewed its regulatory authority under the Act as extending to all market participants regardless of

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[1/] In contrast to Section 6(b), the Nahas court cited (738 F.2d at 496) the explicit authority conferred on the U.S. Department of Justice, under 15 U.S.C. § 1312(d)(2), and on the Federal Trade Commission, under 15 U.S.C. § 57b-1(c), to serve "civil investigative demands" in connection with antitrust investigations, "upon any person who is not to be found within the territorial jurisdiction of any court of the United States, in such manner as the Federal Rules of Civil Procedure prescribe for service in a foreign country." The amendment to the Act contained in Section 101 of the bill is patterned on this quoted language.

their nationality or location. However, if widely accepted, the Nahas decision may impede or defeat enforcement of Commission subpoenas directed to foreign nationals in the future, thereby effectively creating a safe haven for would-be violators of the Act who can insulate their activities simply by conducting transactions on American exchanges from abroad. In the Commission's view, such a result is fundamentally inconsistent with the intent of Congress in passing the Act and wholly ignores the increasingly international nature of United States futures markets. The proposed amendment would clarify the uncertainty created by the Nahas decision and would complement the Commission's existing regulatory program for market surveillance.

Under the Commission's market surveillance program, the primary source of information regarding positions held by both domestic and foreign market participants is the Commission's large trader reporting system. In addition to the large trader reporting system, the Commission may issue a "special call" for specific information concerning any account whether or not the account contains reportable positions.

Commission communications concerning the large trader reporting system and Commission special calls both may be served on any foreign trader or broker by serving the United States futures commission merchant through which trades are executed. 17 C.F.R. § 15.05(b). The FCM must then promptly notify the foreign trader or broker by TELEX or a similarly expeditious means. Failure to respond to the special call may result in a prohibition against further trading except to offset existing open futures contracts. Failure to respond may also result in the imposition of sanctions under Section 6(b) of the Act, including a civil penalty of up to $100,000 for each violation of the Act.

However, the large trader reporting system and special call procedures do not necessarily provide, nor are they calculated to provide, all of the information that may be necessary to ascertain whether a foreign trader or foreign broker has violated the Act or the Commission's regulations. Rather, such a determination often requires the taking of testimony through deposition and/or the analysis of documents, the type of evidence obtained pursuant to subpoena. It is in the area of the Commission's ability to investigate the possible violations of the Act by foreign market participants that the effects of the Nahas decision will be the greatest.

If allowed to stand uncorrected, the Nahas decision may foreclose the Commission from investigating the conduct of foreign market participants irrespective of the magnitude of their involvement in U.S. markets, so long as the trader or other witness remains outside the territorial United States. Thus, even though the foreign participant's conduct is clearly subject to the requirements of the Act,[2] and despite the existence of sufficient contacts with the United States to establish in personam jurisdiction as a matter of due process, the foreign participant may only be subject to the Commission's subpoena power if service can be made in the territorial United States. Congress should act to avoid this result.

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[2] The applicability of the provisions of the Act to persons and conduct outside the United States has been upheld. Tamari v. Bache & Co. (Lebanon) S.A.L., 730 F.2d 1103 (7th Cir. 1984); Psimenos v. E.F. Hutton & Co., Inc., 722 F.2d 1041 (2d Cir. 1983); Cresswell v. Prudential-Bache Securities, Inc., 580 F. Supp. 55 (S.D.N.Y. 1984); Alpa S.A. Agroindustrial Alemano v. ACLI International, Inc., 573 F. Supp. 1070 (S.D.N.Y. 1983).

Court of Appeals Review

Pursuant to specific sections of the Commodity Exchange Act, many Commission orders are subject to judicial review only in the United States Courts of Appeals. However, the Act is silent with respect to other types of final Commission action, and thus judicial review of those actions would initially occur in the United States District Courts. Section 103 of the bill would add a new Section 24 to the Act to provide that all these other final Commission actions would also be reviewable only in the Courts of Appeals.[1] New Section 24 would therefore make judicial review of all final Commission rules or orders similar to that of other independent regulatory agencies.[2] The amendment would also promote administrative and judicial efficiency and assure a more prompt and definitive resolution of controversies arising under the Act than is available in the District Courts.[3]

1/ Section 103 will not amend those sections of the Act which already provide for Court of Appeals review.

2/ Among those agencies whose statutes contain a general Court of Appeals review provision governing their rules or orders are the following: Securities and Exchange Commission, 15 U.S.C. § 77i (Securities Act); 15 U.S.C. § 77vvv(a) (Trust Indenture Act); 15 U.S.C. § 78y (Securities Exchange Act); 15 U.S.C. § 79x (Public Utility Holding Company Act); 15 U.S.C. § 80a-42 (Investment Company Act); 15 U.S.C. § 80b-13 (Investment Advisers Act); Federal Labor Relations Authority, 5 U.S.C. § 7123; Federal Reserve Board, 12 U.S.C. § 1848; Federal Trade Commission, 15 U.S.C. § 21(c) (Clayton Act); 15 U.S.C. § 45(c), 15 U.S.C. § 57a(e)(1)(A) (FTC Act); Federal Energy Regulatory Commission, 15 U.S.C. § 717r (Natural Gas Act); 15 U.S.C. § 3416(b) (Natural Gas Policy Act); 16 U.S.C. § 8251 (Federal Power Act); Consumer Product Safety Commission, 15 U.S.C. § 2060; Food and Drug Administration, 21 U.S.C. § 371; Federal Communications Commission, 28 U.S.C. § 2342(1), 47 U.S.C. § 402(a); Federal Maritime Commission, 28 U.S.C. § 2342(3); Nuclear Regulatory Commission, 28 U.S.C. § 2342(4), 42 U.S.C. § 2239; Interstate Commerce Commission, 28 U.S.C. § 2342(5), 28 U.S.C. § 2321; National Labor Relations Board, 29 U.S.C. § 160(f); Occupational Safety and Health Administration, 29 U.S.C. § 660; Federal Mine Safety and Health Review Commission, 30 U.S.C. § 816; and Environmental Protection Agency, 33 U.S.C. § 1369(b) (Federal Water Pollution Control Act); 42 U.S.C. § 7607 (Air Quality Act).

3/ Section 103 of the bill is drafted to cover only review of Commission action taken under the substantive provisions of the Act. Thus, certain types of Commission determinations would not be subject to direct Court of Appeals review under the amendment. These would include orders, such as those issued pursuant to the Freedom of Information Act, for which another statute explicitly provides for District Court review. See 5 U.S.C. § 552(a)(4)(B); Commercial Envelope Manufaturing Co. v. SEC, 450 F.2d 342 (2d Cir. 1971). With these exceptions, all judicially reviewable Commission action taken
(Footnote continued)

A primary function of the United States District Courts is to serve as the initial fact finders in litigated disputes. In contrast, the Courts of Appeals generally serve the function of reviewing the record compiled below and determining whether the proper legal standards have been applied to the factual record. Appellate courts do not, as a rule, consider evidence not contained in the lower court record. For this reason, the Federal Rules of Appellate Procedure do not provide for litigants to obtain routine discovery concerning their cases.

In a variety of contexts, the Commission plays a role in contested proceedings analogous to that of a District Court. The Commission considers the evidence presented to it, makes findings of fact, and applies the relevant law in issuing its orders. In other situations the Commission itself acts as an appellate tribunal, assessing the record made before the trier of fact. In all of these cases, the Commodity Exchange Act presently provides that an aggrieved party may seek review of the Commission's decision only in the Courts of Appeals. This is the case, for example, under Section 6(b) of the Act, 7 U.S.C. § 9, with respect to review of Commission decisions to deny, suspend, or revoke the registration of a commodities professional. Section 6(b) specifically provides that the Commission's factual findings, if supported by the weight of the evidence, shall be conclusive.4/ Thus, while a Court of Appeals will review the record to assure that there is factual support for the Commission's order, it will not reopen the record to consider additional evidence, nor will it reevaluate the existing evidence to make its own findings of fact. This reviewing function is thus equivalent to the role of a Court of Appeals in reviewing the factual findings of a District Court.5/

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under the Act would be reviewable only in the Courts of Appeals. Of course, no court review would be available if a petitioner failed to satisfy traditional prerequisites for judicial review, such as ripeness and exhaustion of administrative remedies. See, e.g., Investment Company Institute v. Board of Governors, 551 F.2d 1270, 1275 n.6, 1278 (D.C. Cir. 1977); Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 800-01 (D.C. Cir. 1965).

4/ A similar provision is found in Section 6(a) of the Act, 7 U.S.C. § 8(a), which concerns Commission orders suspending or revoking contract market designations. Other sections of the Act provide for Court of Appeals review of Commission orders pursuant to the procedures described in Sections 6(a) and 6(b). Among these are Section 6, 7 U.S.C. § 8 (refusal to designate as contract market); Section 6(c), 7 U.S.C. § 13b, (cease and desist orders); Section 14(e), 7 U.S.C. § 18(e), (reparation orders); and Section 17o(4), 7 U.S.C. § 18o(4), (orders declining to review registration decisions of registered futures associations). In addition, Section 8a(9) of the Act, 7 U.S.C. § 12a(9), provides for limited Court of Appeals review of Commission emergency actions.

5/ Statutes providing for direct Court of Appeals review of agency orders typically contain a "weight of the evidence" standard of review, such as that in Section 6(a) and 6(b) of the Act, or a "substantial evidence" standard like that contained in proposed Section 24. District Court review under the Administrative Procedure Act generally consists of determining whether the agency

(Footnote continued)

In other instances, however, the Act does not provide Court of Appeals judicial review for actions taken by the Commission. These Commission actions can be divided into three broad categories. The first involves adjudicatory-type proceedings similar to those for which Court of Appeals review is already provided under present law. Examples are Commission action in reviewing exchange disciplinary actions, Section 8c, 7 U.S.C. § 12c, and in reviewing registered futures association disciplinary actions, Section 17(i), 7 U.S.C. § 21(i).[6/] The second group involves Commission actions that are akin to general rulemaking, particularly when the proceedings involve public notice and comment. These actions include contract market designations pursuant to Section 5 of the Act, 7 U.S.C. § 7, approval or disapproval of contract market rules under Section 5a(12), 7 U.S.C. § 7a(12), and alteration of contract market rules under Section 8a(7), 7 U.S.C. § 12a(7). Finally, the Commission frequently issues regulations of general applicability pursuant to its statutory authority, such as those governing exchange trading of commodity options, 17 C.F.R. Part 33. In the absence of a specific provision directing that judicial review of these categories of Commission action be in the Courts of Appeals, review would, in the first instance, take place in the District Courts. See Administrative Procedure Act, 5 U.S.C. §§ 702, 704.

There are several reasons why it would be preferable for judicial review of all final Commission rules and orders to occur initially in the Courts of Appeals, as is already the case for other regulatory agencies. First is the matter of administrative efficiency and, in particular, the saving of Commission staff resources. Any case that is initially litigated in a federal District Court could eventually be appealed to a Court of Appeals and thus would entail a two-step litigation process. In each of the three categories described above, the factual record has been fully developed, and the Commission has enunciated the basis for its decision. Under those circumstances, nothing would be gained by subjecting the decision to trial-level review, followed by review in the Court of Appeals. Rather, the action would be well suited for Court of Appeals review in the first instance. Such an appeal procedure

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findings are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law," 5 U.S.C. § 702(2)(A), although determinations based on formal hearings "on the record" are reviewed under a "substantial evidence" test pursuant to 5 U.S.C. § 706(2)(E). Nevertheless, there is an "emerging consensus . . . that the distinction between the arbitrary and capricious standard and substantial evidence review is largely semantic, and that 'in the review of rules of general applicability made after notice and comment rulemaking, the two criteria . . . tend to converge.'" Pacific Legal Foundation v. Department of Transportation, 593 F.2d 1338, 1343 n.35 (D.C. Cir.), cert. denied, 444 U.S. 830 (1979), quoting Associated Industries of New York State v. United States Department of Labor, 487 F.2d 342, 349-50 (2d Cir. 1973).

[6/] Section 302 of Title III of the bill specifically proposes to amend Section 17(i) so as to have Commission review of registered futures associations disciplinary actions subject to court of appeals review under Section 6(b) of the Act.

would also save judicial resources, as well as those of the party challenging the Commission's action.[7]

A related advantage of Court of Appeals review is the likelihood of obtaining a definitive ruling on a contested matter more promptly. Injecting an additional level of judicial review merely delays the time in which important issues of commodities law are resolved. Moreover, a Court of Appeals ruling has a binding effect upon the entire circuit, and thus Court of Appeals review will promote a more consistent body of commodities law. A District Court ruling, in contrast, has very limited precedential effect. Consequently, District Court review might require the Commission, or, for that matter, members of the industry, to relitigate identical issues with unwanted frequency.

Finally, avoiding District Court litigation will diminish the opportunity for attempts at unwarranted intrusion into the mental processes of Commission members. While such intrusion should not be permitted, see generally United States v. Morgan, 313 U.S. 409, 421-22 (1941), the Commission might be required to expend resources to fight such discovery attempts at the District Court level under the discovery provisions of the Federal Rules of Civil Procedure. There would be a strong presumption against any effort to seek such discovery at the Court of Appeals level. For the foregoing reasons, Congress should enact proposed Section 24 of the Act.

Ex parte Appointment of Temporary Receivers

Section 104 of the bill would amend Section 6c of the Act to empower the Commission to seek in federal district court the ex parte appointment of a temporary receiver pending a hearing to decide whether a permanent receiver should be appointed or such other hearing as the court may order. The bill would enhance the Commission's existing authority to obtain ex parte restraining orders to prohibit suspected law violators from destroying books and records or removing funds or other property.

Section 6c of the Act authorizes the Commission to bring an action in federal district court to enjoin unlawful conduct. Prior to enactment of the Futures Trading Act of 1982, Section 6c prevented the Commission from obtaining a restraining order or injunction on an ex parte basis. During the 1982 reauthorization process, the Commission requested that Congress lift the prohibition on ex parte restraining orders. The Commission noted that prior notice to persons suspected of violating the law might result in their destroying books and records or dissipating customers' funds. Congress agreed and amended Section 6c to permit the courts to issue ex parte restraining orders: (a) to prohibit any person from destroying, altering or disposing of, or refusing to permit authorized representatives of the Commission to inspect, any books and records or other documents and/or (b) to prohibit any person from withdrawing, transferring, removing, dissipating, or disposing of any funds, assets or other property.

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[7] The Senate Report accompanying the Securities Act Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97, 158-60 (1975), which, inter alia, expanded Section 25 of the 1934 Act, 15 U.S.C. § 78y, to provide direct Court of Appeals review of many SEC rules, explained several of the advantages of placing review in the Courts of Appeals:

> [T]he Committee [on Banking, Housing and Urban Affairs] believes the bill would expedite final resolution of the major policy determinations the Commission will be called upon to make with respect to the national market system and the rationalization of the self-regulatory system . . . . The Court of Appeals appears to provide the most appropriate forum for this review in light of the fact that the District Court's fact finding function is rarely necessary and the questions subject to review are likely to end up in the higher court anyway.

S. Rep. No. 75, 94th Cong., 1st Sess. 37 (1975).

This new authority of the Commission has worked well, but has also created a dilemma. As Section 6c is presently written, there is no express power for the court to appoint a receiver on an ex parte basis to assure that books and records and assets will be fully protected. A receiver may be appointed only after notice and a hearing on the application for the appointment of a receiver. The period between the issuance of the ex parte restraining order and the hearing on the application can be as long as fifteen to twenty days. During this often critical period, the books and records and assets might be substantially disposed of or dissipated.

For example, in many instances in which the Commission is taking law enforcement action against an off-exchange boilerroom, the Commission will seek and obtain an ex parte restraining order to protect the books and records and to freeze the assets of the off-exchange operation. Nevertheless, no independent person is in place to ensure that the books and records and assets are protected.1/ These assets could include open positions in the legitimate futures markets, which would go unmanaged after the issuance of the ex parte restraining order until a receiver has been appointed. Margin calls may be made to these futures accounts, but because the assets are frozen and no one is in place to manage the operation, the margin calls are not met. The futures commission merchant carrying the accounts might liquidate profitable positions to meet margin calls on unprofitable positions regardless of whether it is in the best interests of the operation or its customers.

1/ In at least one case, it is suspected that a defendant disposed of books and records and transferred the assets of a defendant after the court had issued an ex parte restraining order. In that case, Commodity Futures Trading Commission v. FITC, Inc., No. C-85-1555 (N.D. Cal. 1985), the receiver's report estimated that several tens of thousands of dollars worth of silver, gold and other assets disappeared between the period of the entry of the ex parte freeze order and the appointment of the receiver.

Typically, in these cases where the Commission is successful in obtaining an ex parte freeze order, large amounts of precious metals and other assets are left unattended in unsecure safes, vulnerable to theft by principals of these operations or by third parties during the period between that order and the appointment of a receiver. See Commodity Futures Trading Commission v. Brazier Corporation, Inc., Civ. No. 84-2066 (C.D. Cal. 1984).

Further, during the period of the ex parte freeze of assets, the salaries of the employees of the operations cannot be paid. Often the employees quit, further limiting the ability of the operation to preserve any assets it may have. The appointment of a temporary receiver could eliminate much of this disruption to the firm's operations.

The amendment to Section 6c of the Act proposed by the bill will allow the Commission to seek the ex parte appointment of a temporary receiver.[2/] The temporary receiver would be appointed to administer the ex parte order over books, records and assets and to perform such other duties as the court may specify. The temporary receiver would remain in place pending the hearing on the application for the appointment of a permanent receiver, or pending such other hearing as the court may order. The temporary receiver would be in place to protect the books, records and assets of the defendant, to carry on day-to-day operation of the firm, e.g., paying salaries and other legitimate expenditures, and to meet margin calls or liquidate unprofitable positions. The temporary receiver would then be protecting the assets of the operation which ultimately could be distributed to the firm's customers.

TITLE II - LEVERAGE TRANSACTIONS

Title II of the bill would amend the Commodity Exchange Act to exclude entirely leverage transactions from regulation under the Act. Under this amendment the Commission would neither be required nor authorized to regulate leverage transactions as a distinct form of commodity instrument.

Background

In the Commodity Futures Trading Commission Act of 1974, the Commission was first given exclusive regulatory jurisdiction over gold and silver leverage transactions. In 1978 Congress banned leverage transactions in agricultural commodities and extended the Commission's exclusive leverage jurisdiction to all other commodities in addition to gold and silver. Between 1974 and 1982, the Commission adopted three regulatory measures for leverage transactions: two temporary moratoria on the entry of persons into leverage businesses involving gold and silver bullion or coins (17 C.F.R. § 31.1 (1985)) or other commodities (17 C.F.R. § 31.2 (1985)), and an antifraud rule (17 C.F.R. § 31.3 (1985)).

With the enactment of the Futures Trading Act of 1982 Congress significantly amended the Commission's authority to regulate leverage contracts. Previously, the Commodity Exchange Act required that any leverage transaction determined by the Commission to be a

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2/ The concept of the ex parte appointment of a temporary receiver is not new and has been upheld as constitutional in highly regulated fields to protect the public interest in emergency situations. See, e.g., Fahey v. Mallonee, 322 U.S. 245 (1946) (upholding the authority of the Federal Home Loan Bank Board to appoint a receiver or conservator of a savings and loan association on an ex parte basis pending a subsequent hearing). Courts have standards in place by which to consider requests for the ex parte appointment of temporary receivers which will ensure that that remedy will not be used indiscriminately. See, e.g., Civil Rule 232 for the United States District Court for the Eastern District of California.

contract for future delivery within the meaning of the Act be regulated as such.[1] The 1982 Act, however, repealed this provision.[2] In its place Congress enacted a new Section 19(c) specifically to require the Commission to regulate leverage transactions in gold or silver bullion or bulk coins or in any other commodities, except those subject to the 1978 prohibition on agricultural leverage transactions. New Section 19(c) also vested in the Commission the authority to prohibit any leverage transaction for the delivery of any commodity that was not permitted by the rules, regulations and orders of the Commission in effect on December 9, 1982, if the Commission determines that any such transactions would be contrary to the public interest.

As a result of the direction given by Congress in 1982, the Commission in 1984 and 1985 issued interim final leverage regulations applicable to both long and short leverage transactions in gold and silver bullion and coins, copper, platinum and certain foreign currencies. The Commission is now proposing that Congress eliminate the regulation of leverage transactions from the Act.

Statutory Proposal

The amendments proposed by Title II of the bill would remove from the Act virtually all references to leverage transactions.[3] The amendments would thus eliminate what the Commission perceives as the historical and unjustified statutory distinction between leverage and futures contracts. In the Commission's view leverage transactions are legally and economically indistinguishable from futures contracts and therefore do not warrant separate statutory treatment.

Under the amendment the Commission would remain authorized to bring law enforcement proceedings against those firms marketing off-exchange futures contracts, including leverage contracts, and the states, in addition to initiating or participating with the Commission in such enforcement proceedings, could enact and enforce legislation prohibiting the marketing of those contracts. However, if Title II is enacted, the Commission believes that those firms which the Commission has registered under its existing regulations as leverage transaction merchants could appropriately be afforded a sufficient period of time to modify their businesses so as to be in full compliance with the law. Therefore, language could be included in the Committee reports accompanying the legislation expressing the intent of Congress that the Commission refrain from taking any enforcement action against such firms based solely on their continuing to offer or sell leverage contracts or service existing accounts during the period from enactment of the bill until, for example, January 1, 1988.

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[1] See § 217 of the Commodity Futures Trading Commission Act of 1974, 7 U.S.C. § 15a(a) (1976), and Section 19(d) of the Commodity Exchange Act, 7 U.S.C. § 23(d) (Supp. V 1981).

[2] In repealing this provision, Congress noted that the Commission retains authority to take appropriate action under any other provision of the Act against off-exchange futures transactions, including transactions "masquerading" as leverage contracts. See H.R. Rep. No. 964, 97th Cong., 2d Sess. 51 (1982).

[3] Certain references to leverage transactions would be retained. Thus, under Section 8a of the Act, 7 U.S.C. 12a, prior violations of the Act's leverage provisions in Section 19 would continue to constitute a statutory disqualification from registration with the Commission. Nor does Title II seek to amend the references to leverage transaction merchant in the Bankruptcy Code, Chapter 7 of Title 11 of the United States Code.

In this connection, the Commission points out that Title II would not necessarily terminate the business of these firms. Specifically, it may be possible that the current leverage firms could, albeit with some modifications to their operations, continue in business by undertaking the marketing of cash and/or installment sale transactions. While this business would be subject to any existing state regulation, such cash and installment transactions would be permissible even in states that had adopted the North American Securities Administrators Association Model State Commodity Code.[4/] Support for this view of leverage operations as being not too dissimilar from cash or installment sales is suggested by the recent Congressional testimony submitted on behalf of Monex International, Ltd. That testimony stated that in the marketing of leverage contracts, delivery is encouraged by the leverage dealer with the result that many leverage customers intend to and ultimately do take (or make) delivery. As a result leverage dealers maintain large stocks of physical commodities to satisfy their customers' delivery needs. It was also stated that leverage dealers are in direct competition with, among others, firms which offer cash-and-carry transactions, precious metals dealers, and coin shops.[5/] In light of this testimony, and assuming it also generally describes the businesses of the other few firms operating pursuant to the interim leverage rules, it is not entirely unreasonable to suggest that these leverage businesses, with some modifications to their operations, could conduct themselves in accordance with the Model Code.

TITLE III - REGISTERED FUTURES ASSOCIATIONS

The basis for the amendments proposed by Title III of the bill was set forth at pages 145-153 of the Commission's December 1985 Report to Congress under Section 237 of the Futures Trading Act of 1982 regarding the National Futures Association (NFA). A copy of these pages follows, to which have been added bracketed references to the relevant sections in Title III of the bill.

4/ In general, the Model Code is designed as a modern bucket shop law to prohibit the types of off-exchange commodity transactions which have been fraught with customer abuses. Nevertheless the Code does permit the marketing of any commodity contract for the purchase of precious metals which requires, and under which the purchaser receives, within seven calendar days from the payment of any portion of the purchase price, physical delivery of the quantity of precious metals purchased by the payment. In this regard, physical delivery is deemed to have occurred if, within the seven day period, the precious metals purchased are delivered, in segregated or fungible bulk form, into the possession of a depository (other than the seller) which is either a financial institution or other specified entity.

In addition, the Model Code permits the offer and sale of any contract under which the purchaser receives, within 28 calendar days from the payment of any portion of the purchase price, physical delivery of the total amount of the commodity to be purchased under the contract.

5/ See Regulation and Trading of Leverage Contracts and Dealer Options: Hearings Before the Subcommittee on Conservation, Credit and Rural Development of the House Committee on Agriculture, 99th Cong., 1st Sess. 294, 295, 298, 299 (1985) (statement on behalf of Monex International, Ltd.).

Commission Oversight -- Legislative Proposals

In order to facilitate the Commission's continuing oversight program for NFA and NFA's implementation of key self-regulatory functions, the Commission is proposing legislative amendments designed to insure that the Commission's oversight powers under the Act with respect to NFA are more closely comparable to those regarding the contract markets, the other self-regulatory organizations under the Commission's jurisdiction.

[Sec. 304 -- Alteration or Supplementation of Association Rules]

A critical component of this oversight process is the authority provided under the Act with respect to those organizations' rules. Specifically, within limits and subject to procedures established by the Act, the Commission is empowered (i) to approve or disapprove new rules proposed by NFA or the contract markets, (ii) to abrogate existing rules, or (iii) to request, and ultimately to order, alterations in and supplementations to the rules of the self-regulatory organizations.

These rule-related authorities reflect the underlying structure of self-regulation as embodied in Federal commodity statutes since 1922 -- that exchange and industry officials be permitted to govern their own affairs as regulators of first resort, but subject to the authority of a Federal overseer to intervene, where appropriate, to protect the larger public interest. The Commission is therefore empowered to review all NFA rules (including NFA's Articles of Incorporation and Bylaws) and changes thereto before they can be made effective. The Commission is further directed to disapprove any such

rule which it finds to be inconsistent with NFA's statutory charter or otherwise in violation of the Act or the Commission's regulations.

This need for Federal oversight is magnified in the case of NFA because NFA membership is mandatory for individuals and firms doing business in exchange-traded futures and options. By comparison, membership in a contract market is voluntary and not essential to a registrant who wishes to conduct a futures or option business. Indeed, to the extent Congress has exempted the self-regulatory activities of registered futures associations from the antitrust laws, it is precisely because Congress has also established statutory mechanisms for the oversight and impartial review by a Federal agency of the activities of these private organizations.

Despite similar policy foundations, however, differences exist in the specific legal mandates underlying the Commission's rule oversight authority for NFA on the one hand and designated contract markets on the other. The most significant difference involves the Commission's power to alter or supplement the rules of a self-regulatory organization. Specifically, under the current statutory formulation, the Commission's authority with respect to the exchanges is significantly broader than that with respect to NFA.

Section 8a(7) of the Act permits the Commission, subject to various required procedures, to alter or supplement rules of the contract markets where such changes are "necessary or appropriate for the protection of persons producing, handling, processing, or consuming any commodity traded for future delivery on [a] contract market . . . or for the protection of traders or to insure fair dealing in commodities traded for future delivery on such contract market." The Act then provides examples of rules falling within this category, including those relating to terms and conditions of

contracts, trading requirements, financial safeguards, and the manner of accounting for customers' orders, transactions, and accounts.

During the past ten years, the Commission needed to invoke its authority to alter or supplement or to disapprove exchange rules under Sections 8a(7) or 5a(12), respectively, on only five occasions. (These two authorities -- disapproval and alteration or supplementation -- were sometimes used simultaneously, as was the case where repeal or disapproval of the rule in question would have resulted in an unacceptable gap in exchange rules governing a particular subject.) Each of these proceedings, however, involved matters of critical importance, such as the listing of delivery months for futures contracts or the procedures for establishing settlement prices, where the Commission believed it necessary to exercise its authority to assure fair dealing by the self-regulatory organizations.

The Commission's correlative authority with respect to NFA is considerably more narrow. Section 17(k)(2) authorizes Commission alteration and supplementation of NFA rules, again subject to required procedures, only where "necessary or appropriate in the public interest or to effectuate the purposes of this section [authorizing the establishment of registered futures organizations such as NFA]" with respect to three specified, largely procedural, areas:

> (A) the basis for, and procedure in connection with, the denial of membership or the barring from being associated with a member or the disciplining of members or persons associated with members, or the qualifications required for members or natural persons associated with members or any class thereof;
>
> (B) the method of adoption of any change in or addition to the rules of the association; [and]
>
> (C) the method of choosing officers and directors.

The difference in standards between the Commission's authority with respect to rules of NFA and the exchanges appears

to result in several anomalies. For instance, while the Commission is authorized to require alteration in an exchange's rules regarding minimum financial requirements for member futures commission merchants, the Commission apparently would not be authorized to require such changes to be made in identical rules promulgated by NFA. Current statutory language also appears to exclude Commission alteration of NFA rules concerning sales practices, despite the fact that NFA has primary responsibility for this area and is required by the Act to establish and implement a comprehensive sales practice program.

Should a need for subsequent mandatory alteration arise, the Commission's only alternative would, therefore, be either to abrogate any applicable NFA rules in their entirety or to revoke NFA's registration under the Act; neither of these alternatives is a practical approach. Similarly, if the Commission were to determine that shortcomings in NFA's self-regulatory program could be rectified only by actually supplementing (rather than altering or deleting) NFA's existing rules, the Commission would similarly lack the power under the Act, at least as it is now constituted, to compel NFA to make such a change.

The Commission therefore proposes that Section 17(k) be amended to make the Commission's authority to alter or supplement NFA rules parallel to, and no less broad than, the Commission's comparable authority with respect to the self-regulatory activities of the contract markets. The use of such mandatory provisions is viewed by the Commission only as a last resort. Indeed, the authority that would be provided by this amendment is not likely to be invoked in view of the cooperative relationship that has been fostered between the Commission and NFA during the past three years. It is nonetheless possible that a situation could arise in the future where such measures would be essential for the Commission effectively to protect the public

interest, as has occurred in the few cases involving the contract markets during the first ten years of the Commission's existence. In any event, before acting to change rules of either NFA or of an exchange, the Commission would still be required to first request that the self-regulatory organization adopt the rule change voluntarily, and provide the affected organization with notice and an opportunity for a hearing.

Notably, this policy of placing exchanges and registered industry self-regulatory organizations on an equal footing for purposes of Commission rule oversight is similar to the approach followed in the securities field. Section 19(c) of the Securities Exchange Act of 1934 authorizes the Securities and Exchange Commission to "abrogate, add to, and delete from" the rules of either a national securities exchange or a registered securities organizations (such as the National Association of Securities Dealers) within specified limits, under identical procedures and standards.

[Sec. 303 -- Rule Review Procedures]

A similar, though less troubling, disparity is found in the statutory procedures concerning the Commission's authority to review and approve or disapprove new rules proposed by NFA and exchanges. While Section 17(j) of the Act requires that the Commission act on NFA rule proposals within 30 days unless a longer period is requested by either NFA or the Commission, no such limitation exists in Section 5a(12), which establishes rule review procedures with respect to the exchanges. In practice, the 30-day provision in Section 17(j) has not had a tangible impact on Commission review of NFA rules and the difference appears to be purely technical.

A similar 30-day requirement formerly applied to the Commission's review of exchange rules under Section 5a(12) but was repealed in 1982 when both Sections 5a(12) and 17(j) were substantially amended to establish the current, more streamlined rule review procedure. The legislative history of those amendments does not indicate any reasons why the otherwise parallel rule review procedures should differ in this relatively insignificant respect. The Commission therefore proposes that the NFA rule review process be made consistent with the similar provision governing other self-regulatory organizations.

Disciplinary Proceedings -- Legislative Proposals

As described earlier in this Report, NFA's disciplinary system for violations of its rules by members or their associated persons includes a summary procedure called a "member responsibility action" which can and has been used by NFA to obtain expeditious compliance with its rules and provide immediate protection to customers. To provide only a few examples, NFA has used the MRA procedure to prevent the further solicitation of customers where a member firm was not in compliance with applicable disclosure requirements, to order the transfer of customers' accounts where member futures commission merchants and introducing brokers could not demonstrate compliance with capital requirements, and to prevent the dissipation of customer funds.

[Sec. 301 -- Disciplinary Actions]

The Commission generally regards the MRA as a powerful and appropriate tool for self-regulatory bodies such as NFA to obtain immediate compliance. However, an impediment to the effective use of the MRA procedure -- and to NFA's disciplinary program as a whole -- results from the provisions of Section 17(h) of the Act. Specifically, Section 17(h) presently provides that any person who is the subject of an NFA disciplinary action may appeal that action to the Commission and that any such appeal has the effect of automatically staying the effectiveness of the NFA action. The Commission can lift the stay, but only after notice and opportunity for a hearing, which may consist of affidavits and oral argument. As a result, the effectiveness of NFA's MRA procedure -- which, by its very nature, is designed for use in

instances where immediate action is necessary to protect the markets, customers, or other NFA members -- can be dramatically reduced by providing the respondent an automatic stay merely upon the filing of an application for Commission review, no matter how serious the situation being remedied by the MRA or how insubstantial the purported basis for Commission intervention. Similarly, the effectiveness of any sanctions imposed as a result of formal NFA disciplinary procedures are likely to be diminished if a suspended or expelled member can forestall that result merely by filing an appeal with the Commission.

The appeal provisions of Section 17(h) were not intended to undermine the effectiveness of a self-regulatory compliance system, but rather to insure fundamental fairness for members of the Association against possible arbitrary action. As a result, the incidental effect of the current wording of Section 17(h), which is to weaken the effectiveness of NFA's disciplinary procedures, should be remedied. The Commission, therefore, recommends that Section 17(h) be amended to make the automatic stay provisions of that section inapplicable to NFA disciplinary actions, including member responsibility actions.

Such an amendment would put appeals of NFA disciplinary actions on an equal footing with appeals of exchange-imposed sanctions, where a stay can be granted by the Commission but is not a matter of statutory entitlement. Furthermore, appeals to the Securities and Exchange Commission from disciplinary sanctions imposed by the National Association of Securities Dealers do not delay the effectiveness of the penalties assessed by the NASD unless the SEC orders otherwise. Indeed, while the current provisions of Section 17(h) were originally patterned after those portions of the Securities Exchange Act of 1934 that governed appeals of NASD disciplinary actions to

the SEC, that statute has since been amended to make the granting of a stay discretionary with the SEC and to otherwise facilitate the disciplinary action review process. The Commission, therefore, recommends that similar amendments be made to Sections 17(h) and 17(i) of the Commodity Exchange Act, as discussed below.

While Section 17(h) should be amended to eliminate the automatic stay of NFA disciplinary actions, the Commission's proposal would provide, in Section 17(h)(2), that the Commission is to establish an expedited procedure for the consideration and determination of applications for a stay. The Commission believes that this provision will provide a safeguard for persons who are subject to NFA disciplinary actions comparable to the present automatic stay provisions while ameliorating the unintended consequences of existing law.

Section 17(h) should also be amended to make explicit NFA's duty to file notice of any final disciplinary action promptly with the Commission. While NFA's rules already require NFA to notify the Commission whenever it takes disciplinary action, that obligation should be codified in the Act.

[Sec. 302 -- Commission Review of Association Action]

Under the Commission's proposal, both Sections 17(h) and 17(i) would be amended to make explicit that Commission review of NFA disciplinary actions is available only with respect to final actions, precluding the disruption of the NFA disciplinary process by untimely appeals to the Commission and, ultimately, the courts. (Similar restrictions on the review of Commission enforcement actions are embodied in the judicial doctrine of "exhaustion of administrative remedies.") Section 17(i) should also be amended to authorize the Commission to review only the record before NFA and the submissions of the parties. The actual standards for Commission review of any NFA decision would, however, remain essentially unchanged.

Finally, Section 17(i)(3), which relates to denial of membership in NFA (or to association with a NFA member), should be amended to make the standards for Commission review of a NFA decision similar to those governing NFA disciplinary actions. (NFA disciplinary actions and the provisions for Commission review thereof are applicable only to persons who are already NFA members or associated with such a member.) As with the other suggested amendments to Sections 17(h) and 17(i), the Commission would be authorized to review the record of the proceeding before NFA without having to hear and consider new evidence. These provisions, therefore, would resemble the procedures already established for Commission review of adverse registration determinations made by NFA. (The Commission has recently delegated to NFA the authority to, among other things, deny, suspend, or revoke registration.) In those latter cases, which are governed by the "statutory disqualification" provisions of Sections 8a(2)-8a(4) of the Act and to which Section 17(i) does not apply, the Commission considers the record made before NFA and whether NFA's decision was consistent with applicable requirements but does not engage in time-consuming fact-finding. The Commission believes that a comparable standard should be applied to the review of NFA membership determinations.

TITLE IV - MISCELLANEOUS AMENDMENTS

Certain Prohibited Transactions

Section 9(d) of the Act makes it a felony for a Commissioner or Commission employee to participate, directly or indirectly, in commodity futures, option or leverage transactions or, with certain limited exceptions, in investment transactions in an actual commodity. In view of the vast increase in types of commodities on which futures contracts are now traded, in Title IV of the bill, the Commission is proposing changes to Section 9(d) to eliminate certain of these restrictions. The amendments are designed to enable the Commission to administer Section 9(d) flexibly so as to assure that transactions that do not pose any conflict of interest concerns are not subject to the broad prohibitions contained in the present law. The proposed amendments should also obviate the need for the Commission to seek additional amendments to Section 9(d) in the future as the commodity markets continue to expand into new areas.

The first change to Section 9(d) effected by the bill would be to limit the restrictions on investment transactions in actual commodities to cover only those transactions which involve the use of nonpublic information or which are effected by means of a Commission-regulated instrument, such as a commodity futures contract.*/ This proposal is consistent with Congressional revisions enacted in 1982. At that time Congress amended Section 9(d) to permit Commissioners and employees to invest in U.S. Government Securities, certificates of deposit or similar financial instruments so long as no nonpublic information is used and the transaction is not effected by an instrument regulated by the Commission. In the Commission's view, there is no reason why the philosophy underlying this 1982 amendment should not apply to investments in other commodities. So long as nonpublic information is not used and the commodity options or futures markets are not employed, the Commission believes the conflict of interest concerns underlying Section 9(d) are greatly diminished and its employees should be free to invest in actual commodities. The bill generally would permit these types of investments.

However, the bill does prohibit those investment transactions in actual commodities that are specified by Commission rule. The Commission believes this provision to be necessary in order that the Commission will be able to adopt rules to avoid the appearance of conflicts of interest in certain instances. For example, various stock indexes are both the subject of futures contracts and options on futures contracts. Investment in these indexes would still be prohibited if effected through commodity futures and options contracts, since these are instruments regulated by the Commission. Some of these indexes, however, also underlie options traded on a national securities exchange. The Commission questions whether it would be appropriate to permit its employees to acquire an interest in these stock indexes by use of instruments which resemble Commission-regulated options.

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*/ Investments transactions in actual commodities permitted under existing law would continue to be permitted under the amendments proposed in Title IV.

The second change effected by the bill would be to empower the Commission to develop appropriate exceptions to the absolute restrictions against participation in futures and options transactions. These exceptions would be made only when the Commission determined that they pose no conflict of interest concerns and are otherwise consistent with Congressional intent in enacting Section 9(d), such as modest holdings in large mutual funds that hedge their portfolio in the futures market. Of course, notwithstanding the adoption of any such exceptions that would permit Commission personnel to engage in certain transactions, all Commissioners and employees would continue to remain subject to the criminal provisions of Section 9(e) of the Act. That provision bars any Commissioner or employee from divulging confidential information which may tend to affect market prices to any other person with the intent to assist that person to participate in commodity transactions.

Reauthorization

Section 12(d) of the Commodity Exchange Act authorizes the appropriations of such sums as are required to carry out the provisions of the Act through the fiscal year ending September 30, 1986. Section 402 of this bill extends the authorization for such appropriations for six years, until the fiscal year ending September 30, 1992, at which time the Congress will review the operations of the Commission in order to determine whether to authorize appropriations for the activities of the Commission beyond that date.

TESTIMONY OF ROBERT K. WILMOUTH
PRESIDENT
NATIONAL FUTURES ASSOCIATION

Mr. Chairman, Members of the Committee:

I am Robert K. Wilmouth, President of National Futures Association, the nationwide self-regulatory organization for the futures industry. Four years ago I appeared before you in a very different capacity with no idea that I would shortly be called to help build NFA into a powerful regulatory force for the protection of futures customers. Nevertheless, I joined my voice with many others in making a promise for NFA. As president of the oldest self-regulator in the futures industry I was confident of the industry's resolve to continue to deliver effective and efficient self-regulation. Four years ago that promise was articulated for the entire futures industry by Leo Melamed, NFA's founder and Chairman, when he said "We are prepared, willing and capable of sharing the regulatory burden and costs . . . *if given a chance*."*

You gave us that chance. NFA exists today because you believed in the premise of self-regulation and the promise of NFA. But you also wisely required accountability by setting ambitious performance goals for NFA and by requiring a report on NFA's first three years. I am pleased to say that the CFTC's report concludes that NFA has met those goals. NFA has also prepared a report entitled *The First Three Years* which has been separately supplied to the members of the Committee and staff. I come before you today to highlight NFA's Report and demonstrate that NFA is a promise fulfilled.

● NFA fulfilled its promise to relieve the CFTC of the burdens and costs of direct regulation facilitating the allocation of its resources in areas essential and appropriate for continued industry growth and to assure industry accountability. In its first three years NFA has spent more than $37 million in its operations. Even subtracting the cost of CFTC oversight and the amount of fees the CFTC might have collected over that time, NFA's net contribution toward federal government savings exceeds $35 million. Because of NFA, the CFTC no longer routinely performs financial or sales practice audits. Instead, NFA has performed nearly one thousand on-site financial, operational and sales practice audits and examinations saving the CFTC the 105 staff positions each year that would be needed by the CFTC to accomplish the same result.

● NFA fulfilled its promise to fill the gap where no self-regulator or government agency previously had a real presence. NFA has had a tremendous regulatory impact on non-exchange member futures professionals, increasing voluntary compliance through patient auditing, counseling and educational efforts. Although the CFTC had only been able to audit sporadically in this area, NFA has provided a guiding hand to many professionals who had never before had contact with *any* regulator.

● But NFA also fulfilled its promise to apply a firm hand where needed. NFA's investigative program detects and exposes violations of NFA Requirements requiring disciplinary measures or immediate remedial action. NFA's Business Conduct Committees have issued numerous Complaints against Member firms. These have resulted in various penalties including stiff fines and, in 8 cases, expulsion from NFA which means exclusion from the futures business. In addition to the disciplinary procedure, NFA has also used its power to immediately remedy a danger to customers through a Member Responsibility Action. An MRA is designed to eliminate a threat by, for example, barring a Member from taking on any new business, or, in appropriate cases, by suspending its membership which, like expulsion, terminates the Member's right to conduct any futures business. NFA took 78 such actions in its first three years which demonstrates our resolve to act quickly and forcefully where necessary.

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* Hearings on S. 2109 Before the Subcommittee on Agricultural Research and General Legislation of the Senate Committee on Agriculture, Nutrition and Forestry 97th Cong., 2d Sess. 114-15 (1982) (Statement of Leo Melamed).

- NFA fulfilled its promise to extend the battle against unethical practices beyond the bounds of the legitimate futures industry. NFA and the CFTC pooled their resources and expertise to help the North American Securities Administrators Association draft a Model State Commodity Code to allow the states to put flesh on the bones of the "open season" provision which you enacted in 1982. This will empower state regulators to stand, as you intended, shoulder-to-shoulder with the CFTC and NFA in the effort to eliminate regulatory safe havens for the unscrupulous. NFA has also worked hard to provide referrals and expert assistance to state and federal regulators and prosecutors. NFA has initiated an investor education program supported by a network of organizations committed to consumer protection. For example, with the cooperation of the CFTC, 120,000 copies of NFA's investor awareness publication have been distributed by the Consumer Information Center during the past seven months.
- NFA fulfilled its promise to promote compliance with high levels of ethical standards in the industry. Through tough new rules and guidelines relating to discretionary accounts, advertising and fee disclosure as well as NFA's "Know Your Customer" Rule, NFA has made giant strides toward refining the standards of ethical business conduct. These rules and guidelines carry the special force which comes from industry consensus after extensive and searching analysis and discussion by actual practitioners serving on NFA's Advisory Committees and governing bodies. In addition, other standards have evolved from the decisions of NFA's Business Conduct Committees. Here again the standards are more compelling because they are determined by practitioners exercising their impartial but informed judgment in actual cases.
- NFA fulfilled its promise to raise the standards of knowledge and proficiency in the futures industry by establishing a uniform industry-wide testing requirement for all new associated persons and a two-year experience requirement for brokerage APs who manage discretionary accounts.
- NFA fulfilled its promise to take over the arduous registration tasks. Not only is NFA now doing virtually everything in the registration area that the CFTC did prior to October 1, 1982, but NFA is also registering IBs, the fastest growing category of registrant, and issuing temporary licenses to all eligible associated persons -- two functions established by the 1982 legislation which the CFTC was never required to perform using its own resources. NFA has devoted over 50 staff people to the task of dealing with over 60,000 active files. NFA continues to use the flexibility available in the private sector to make registration an efficient and effective regulatory tool.
- NFA fulfilled its promise to avoid becoming a duplicative regulatory layer by working closely with the futures exchanges not only to avoid regulatory overlap but also to harmonize existing compliance requirements and establish a single coherent set of high

standards for the entire futures industry.

- NFA fulfilled its promise to provide a fast, fair system to resolve customer claims against futures professionals. With over 1,000 volunteer arbitrators from 47 states, NFA's arbitration program provides fair and impartial arbitration hearings virtually anywhere in the U.S. in an average of less than seven months. These benefits have been recognized, and already NFA's arbitration program is selected by many customer claimants. Needless to say, that has substantially reduced the pressure on the CFTC's reparations program and, along with improvements made by the CFTC, has made reparations run more smoothly.

- NFA fulfilled its promise to be efficient. For example, NFA reduced the number of separate registration forms and fees many brokerage employees were required to file from as many as five down to one. Also, NFA audits are thorough but efficient. The arbitration program, as I said, handles as many filings now as CFTC reparations with a paid full-time staff of four. Finally, NFA uses its state-of-the-art in-house data processing capabilities to speed registration and to automate complicated financial analysis and other surveillance functions which would otherwise occupy many staff hours in laborious manual tasks.

- Also, and I think this is particularly important, NFA fulfilled its promise to avail itself of the best and the brightest talents both from within and without the futures industry. Of the more than 300 employees on our staff today, many have valuable prior experience with brokerage firms, exchanges, public accounting firms, the CFTC and other industry-related organizations. All Compliance personnel undergo an intensive training program in order to be skilled in audit techniques and prepared to execute the compliance programs that NFA has established for its Members. NFA's Legal Department consists of nine attorneys including a senior staff of experienced trial lawyers. In fact, one senior attorney teaches a trial practice course at Loyola University School of Law. NFA's Information Center which fields telephone inquiries is staffed with highly trained and motivated individuals selected for their ability and willingness to serve others. The Registration staff includes people with broad experience with the CFTC and exchange registration programs as well as people with extensive data processing expertise. NFA's Information Systems Department itself is staffed with highly qualified data processing experts, many of whom were intimately involved with designing our basic systems. NFA's Treasurer's office, staffed with a number of CPAs, has established stringent controls over NFA's income, investments and expenditures.

But the staff is only part of the story. Enormously valuable talents and expertise are donated by members of NFA's Advisory Committees, Business Conduct Committees, governing bodies and arbitration panels. Individuals such as former CFTC commissioners, current and former exchange chairmen and presidents, brokerage firm chief executive officers, former CFTC staff, former exchange compliance personnel, floor traders and other experts in the futures industry have donated an estimated 8,000 hours of valuable time.

Finally, and perhaps most importantly, NFA fulfilled its promise to achieve its ambitious goals without spending a single penny of taxpayer money. As an entirely self-financed body, NFA has demonstrated the continued willingness of the futures industry to bear its fair share of the cost of regulation.

Those, in a nutshell, are NFA's accomplishments which, as I said, are described in more detail in NFA's full Three-Year Report. As an organization which has fulfilled its promise, done its job and assumed an important place in the structure of regulation, NFA would now like briefly to offer its views on the CFTC's legislative proposals which impact NFA.

NFA strongly supports two of these proposals. Section 17(h) of the Act now automatically stays an NFA disciplinary action when a Member appeals to the Commission. This provision unintentionally undercuts NFA's authority to protect customers in emergency situations. As the Commission has noted, one of NFA's most effective tools in dealing with such situations is the Member Responsibility Action. MRAs allow NFA to take immediate action to restrict a Member's operations when necessary to protect customers. However, under current law the target of an MRA can nullify its protective effect merely by filing a piece of paper without making any showing whatsoever. The Commission's proposed amendment to Section 17(h) would remedy this situation by making a stay of the action discretionary. NFA wholeheartedly supports this approach.

NFA also favors the proposed amendment to Section 17(i) which offers certain refinements to the process of reviewing NFA actions. We only note that this Section should continue to have the flexibility to be used to review MRAs where the immediate issue is not necessarily the violation of a rule but rather a danger to customers.

NFA must strongly disagree, however, with the Commission's proposed amendment to Section 17(k)(2) of the Act which would give the Commission virtually complete authority to alter or supplement and in essence to write NFA rules. Based on NFA's performance during its first three years, this proposal seems both unnecessary and unwise.

One simple question comes to mind: why now? In 1974, and again in 1978 and still again in 1982, Congress closely examined the role of the as-yet-untested NFA. On none of these occasions did the Congress or the CFTC see a need for the power the CFTC now seeks. You would assume that the power to rewrite NFA's rules would now be sought only if actual experience had shown that NFA had come up short in tackling tough issues. The facts are precisely the opposite. Consider the record:

- On a "Know Your Customer" Rule for the futures industry NFA acted;
- On acceptable content for advertising materials and telephone solicitations NFA acted;
- On proficiency testing for applicants for AP registration NFA acted;
- On disclosure of fees by all NFA Members, on an experience requirement for discretionary trading, on more stringent supervisory requirements, on all of these and other issues as well, NFA acted.

The key to NFA's success in dealing with these difficult issues which had been unresolved for so long has been the unwavering support of the rule development process by NFA Members. Each rule considered by NFA is closely scrutinized, dissected, redrafted and refined by one or more committees of Members, in light of general Member comment, over a period of months before being considered by NFA's Executive Committee and Board of Directors. The end result of the process reflects the expertise and judgment of the scores of individuals who have been involved and the countless hours of careful consideration given each proposal. That sort of intense and dedicated involvement in the rule development process is essential if NFA is to continue to lead the way in the development of customer protection rules for the futures industry.

But the CFTC's proposal threatens NFA's ability to do just that. Under current law, the Commission must approve NFA Rules which are consistent with the requirements of the Act. Within that standard NFA has the freedom to exercise its informed judgment. That freedom would be limited, however, if the Commission could substitute its judgment for NFA's by merely threatening to use its "amendatory veto." There is no incentive to even discuss solutions to tough ethical problems where there is a real possibility that the solution will be freely rewritten. The only incentive the CFTC proposal offers is to let sleeping dogs lie. The current proposal rewards the exemplary performance of NFA's Members by undercutting their authority; by substituting government regulation for self regulation; by transforming a cooperative process with proven advantages into an adversarial one with proven disadvantages; by threatening to make NFA no more than the CFTC's Division of Self-Regulation. In short, this proposal simply does not make sense.

What is perhaps most puzzling about this proposal is why the Commission thinks it is necessary. None of its explanations hold water.

First, the Commission argues that because it has broader authority to alter the rules of the exchanges it needs such authority over NFA. Such an argument places symmetry above substance. NFA is not a contract market. Its interests are different. Its level of congressional guidance is different.

Second, the Commission claims that certain "anomalies" result from its lack of authority to rewrite NFA rules. These are really "mirages" -- perceived problems which do not exist. The Commission's complaint that it is powerless to require NFA to alter its financial requirements is simply wrong. Congress took care of that. Section 17(p)(1) of the Act explicitly requires NFA to adopt and enforce financial requirements which are at least as stringent as those imposed by the CFTC. The Commission already has the authority to alter NFA's financial requirements merely by altering its own. The "anomaly" resulting from the Commission's inability to rewrite NFA sales practice rules is another mirage. Congress used its authority to direct NFA to develop sales practice standards by adopting Section 17(p)(3) in 1982 and NFA responded. Arguably NFA has been more agressive in developing requirements like the "Know Your Customer" Rule than the Commission itself. Furthermore, if the Commission feels that the industry wide ethical guidelines developed by NFA are inadequate, it already has the authority to correct any perceived shortcomings through its own rule making process. This is a far more appropriate means of dealing with such issues than the authority it now seeks.

The fact that its authority to alter exchange rules has been used so infrequently, and never to make the types of changes listed in the proposed amendment, is further proof that the CFTC does not need the power it now seeks. The very existence of such power, however, may dull the aggressive approach to the rulemaking process which NFA Members have taken.

In sum, this proposal does not merely try to fix something which is not broken -- it threatens to break something that is working extraordinarily well.

Finally, the Commission proposes to amend Section 17(j) to delete the requirement that the Commission act on NFA rule proposals within thirty days unless a longer period is requested. NFA believes that whatever minimal incentive the current statute provides for a timely consideration of NFA rule proposals, should not be eliminated.

In conclusion, for the fourth time in twelve years you are taking a close look at the structure of futures regulation. On each prior occasion you have made one consistent point -- you wanted NFA. NFA was only an idea in 1974 which Congress brought into sharper focus in 1978. By 1982 NFA was not only a goal of the Congress but a promise from the futures industry. We asked for the chance to regulate ourselves and you gave us that chance. We think we have made good our opportunity, that we have met and even, perhaps, exceeded your hopes and expectations -- that we have fulfilled the promise. But we believe self-regulation holds still greater promise and we look forward to continuing to strive for its fulfillment.

STATEMENT OF LEO MELAMED, SPECIAL COUNSEL TO THE BOARD, CHICAGO MERCANTILE EXCHANGE

My name is Leo Melamed. I am Special Counsel to the Board and Chairman of the Executive Committee of the Chicago Mercantile Exchange. Also representing our Exchange today are John F. Sandner, Chairman of our Board of Governors and William J. Brodsky, our President.

Mr. Chairman, as you probably know, I have been involved with the futures industry for many years and am the founding Chairman of the National Futures Association. I have also been intimately associated with the Chicago Mercantile Exchange having served the institution in many capacities over the years -- not the least of which as its Chairman in 1972 when it launched the International Monetary Market thus spawning the era of financial futures.

Over the past 15 years, I have helped lead and have participated in the efforts which resulted in making our Exchange and the industry it serves one of the most successful business arenas in the world. During that time period, CME annual volume rose from 3.3 million (1970) to 56.5 million (1985), an increase of 1605%. Few, if any, commercial institutions can equal this record.

Moreover, we have been innovators and catalysts on all business fronts -- inventing new concepts, producing new market tools and spearheading the charge toward internationalization. Indeed, approximately one-third of our business flows from foreign lands bringing the United States approximately $1 billion of foreign margin deposits each day.

Not only has futures volume soared beyond our wildest dreams, not only have our markets expanded into every imaginable sector of agriculture and finance, not only have our markets become an integral part of the commercial world, not only has their usefulness been confirmed by the Federal Reserve Board and other federal agencies, these markets have moved our industry to the cutting edge of market science thereby giving the United States a unique competitive advantage over the rest of the world. Indeed, today our American futures markets are the envy and model of every financial center worldwide.

We cite these credentials, Mr. Chairman, in order to underscore that the complaints we are about to make with respect to our federal regulator do not come from an inexperienced or unqualified source. Indeed, in all our years of service to the industry and interaction with government, we have never been as vexed or as exasperated with federal bureaucracy as we are today.

Mr. Chairman, it is our considered opinion that unless the issues which our industry is bringing before you at these hearings are favorably addressed, we will be stifled by repressive federal regulations which make little sense and are the result of inexperience or motivations beyond our comprehension. As a result, we fear for our future. Our competitive edge over other markets, both domestic and foreign, will be blunted.

ONE MINUTE TIME MARKING

As the foremost example of regulatory meddling in areas which the Commission inadequately comprehends, we cite its recent rule requiring one minute time sequencing of all transactions. Anyone who has witnessed our auction markets in progress knows the futility of that requirement. And yet, our regulators, closing their eyes to reality, insist we shackle these markets with this bureaucratic caprice. If we attempt to comply, Mr. Chairman, it will be at severe cost to the liquidity and efficiency of the transaction process; a cost which will be directly or indirectly borne by hedgers and consumers.

The Chicago Mercantile Exchange and the Chicago Board of Trade are not opposed to improving their enforcement capabilities. Indeed, several years ago we voluntarily instituted a system of computerized surveillance over brokers and traders. Moreover, in furtherance of the CFTC's recent demands for an enhanced audit trail, we made a number of proposals, including the creation of a computerized data base of information inclusive of a sequenced time window with respect to the execution of every public order. This plan will give us sufficient detail to detect and prevent abusive trade practices and manipulations. Unfortunately, this plan has not been accepted by the CFTC.

Mr. Chairman, the desire for an effective audit trail is not unique to the CFTC. It is precisely what the exchanges seek. Public trust and confidence in our markets is the basis for our continued success. As the record clearly shows, we have done quite well and we intend to build on past accomplishments. But "audit trail" ought not become a reason for capricious bureaucratic nonsense. Audit trail must be consistent and compatible with the open outcry system — the hallmark of futures trading and the critical element of our competitive price discovery process.

Mr. Chairman, the CFTC's audit trail demands are totally inconsistent with the lifeblood of futures, its liquidity. Liquidity is the most essential element of our success and is the single most sought-after factor by our competitors. Any qualified cost/benefit analysis of the CFTC demands will clearly demonstrate — as our studies have — that the negative impact to our liquidity base will far outweigh any theoretical advantage of the CFTC's system over our proposal. We cannot in good conscience comply with demands that will: delay the execution and confirmation of customer orders; impair liquidity; widen the bid/ask spread, thereby increasing the cost to hedgers and consumers; increase the FCM cost of doing business; and ultimately give our foreign competition the opportunity to take our business.

Mr. Chairman, we will suggest amendments which will subject our industry to standards compatible with the unique nature of our business and yet will achieve a responsible and effective audit trail.

RULE-MAKING/CAPITAL RULES

The second and equally onerous example of regulatory mishandling involves the new CFTC proposed capital requirements for futures commission merchants. While the universal outcry from the industry may have served to stop this proposal, we cannot be certain and must appeal to you for assistance. Indeed, the processes followed by the CFTC in coming forward with its proposal illustrate why their present rule-making procedures ought to be changed.

The catalyst for this CFTC action was the failure of Volume Investors, a clearing member of the Commodity Exchange (Comex) of New York. While the CFTC's investigation indicated that Volume's failure was the result of rule violations rather than a sign of inadequate industry capital rules, the Commission nevertheless promulgated a new capital rule for the entire industry. The CFTC thus allowed an apparent exception to become cause for a general requirement. In doing so, the CFTC acted without a sufficient study, without sufficient calculations, and without consultation or assistance from private sector experts.

The resulting rule is so harsh that it would close a substantial number of our solvent, safe and established clearing firms. If this rule became effective, it would serve to disenfranchise many within our FCM community for no reason other than that one New York firm violated established regulations. This is a clear example of CFTC rule-making inadequacies from which our industry must be protected. Mr. Chairman, we agree that our capital rule should be reviewed from time to time and strengthened whenever necessary, but not in a knee-jerk fashion or thoughtless manner.

Accordingly, the CME and the CBT have made a legislative proposal to improve the CFTC's rule-making process by invoking proper restraints and safeguards so that our industry can be protected from careless sweeping actions which materially effect our viability.

OPTIONS PILOT PROGRAM

Financial Options

Another serious concern is the CFTC's continuing policy of restricting the number of option contracts that may be traded on each futures exchange. As you know, the CFTC permitted options trading on financial instruments under a three-year pilot program scheduled to end October 1, 1985.

The program includes restrictions on sales practices and contained severe limitations on the number of contracts that can be traded at each exchange. Although the pilot program should have ended, it did not. As a consequence, it has given our competitors, the securities exchanges -- which are not subject to artificial limitations -- a distinct competitive advantage. The SEC wisely permitted their markets to quickly begin trading in instruments from which we were excluded. Futures markets were left at the gate petitioning the CFTC to lift its limits so that they too could file applications for similar contract designation. Although the CFTC eventually responded to these petitions (on an ad hoc basis), the delay injured our competitive posture.

Agricultural Options

The CFTC's more stringent limitations on agricultural options result in a hardship for the entire American agricultural community.

As you know, Mr. Chairman, our farm sector has been hard-hit and the prospects for its recovery are far from bright. The new farm bill has placed a great emphasis on the free market in the hope that farmers will ultimately become less dependent upon government assistance. If this policy is to work, farmers must learn to rely upon free market tools and must be given the advantage of every marketing technique available.

Unfortunately, the CFTC's limitation on the number of option contracts denies American farmers an efficient instrument of price insurance on several agricultural commodities. CFTC policy denies our farmers a hedging tool which can protect them against falling prices and allow them the benefit of gain. It is contrary to the best interests of the farm community. Please note that the National Cattlemen's Association last month resolved to urge we open a feeder cattle option contract. In addition, the National Cattlemen's Association plans to request that the CFTC expand the option pilot program to five agricultural options. At this time, the CME is trading our limit, hog and cattle options. Clearly then, this Committee ought not countenance the restrictive CFTC options policy.

A tangential issue is the CFTC's abuse of its power with respect to the setting of a margining system governing options. We will reserve our complaints at this time because we are hopeful that the Commission will eventually agree with our view and allow the exchanges to assume option margin authority, as Congress intended.

DOUBLE JEOPARDY

Next is an issue relating to the CFTC's misuse of its powers to investigate and prosecute rule violations which have been or are being attended to by the exchanges. In 1982, during reauthorization hearings, we called to your attention the Commission's practice of investigating and re-prosecuting individuals who had already been punished by an exchange. The CFTC promised that it would exercise its discretion and Congress thus gave it four more years.

The record of the CFTC during that period has not been good. The CFTC regularly duplicates investigatory procedures and re-prosecutes without first determining whether the penalty meted out by an exchange was adequate or not. This is a waste of the taxpayers' time and money.

We believe that the CFTC has failed the Congressional test and its discretion ought to be restricted. Accordingly, we have proposed legislation that will bring CFTC actions in line with authority at other similarly-situated federal agencies.

HEDGING

Finally, although we still have a long list of complaints, allow us to merely mention an additional select few.

We wish to call to your attention the CFTC's failure to follow Congressional direction to bring the definition of hedging into line with realities of today's financial markets. We will, however, save your valuable time and refrain from comments on this issue because we know that Dr. Gary Seevers of Goldman Sachs, whose views we support, intends to submit a statement explaining the need for rationalizing the CFTC's hedging definition.

We also wish to offer an opinion that the CFTC's demand for additional rule-making authority over the National Futures Association (NFA) is totally unnecessary. The NFA has been a model self-regulatory institution which has received high commendation from the CFTC itself. There is, therefore, no compelling reason to grant the CFTC the additional authority it seeks.

We would also be remiss not to bring to your attention the fact that the CFTC has continued to be excessively slow in processing designation applications for new contracts. To us, this is a most-exasperating area of regulatory indiscretion. It leaves us with no alternative but to sit idly by while our SEC-regulated competitors receive quick approval and capture our potential market share.

Mr. Chairman, in some instances, such delays are totally without excuse and are nothing short of a "blackmail" approach to use the contract approval process as a means to obtain other concessions from our exchanges. This practice must be stopped.

Of equal importance is the issue of judicial review. The CME and CBT have submitted a proposal in opposition to the Commission's attempt to insulate their rule and decision-making process from effective judicial review.

Similarly, we feel that the CFTC ought be be brought under closer review and scrutiny of Congress. Thus we feel compelled to object to their request for an expanded six-year review process. Indeed, the Commission's departure from reason and sound professional behavior during the previous four years argue in favor of a shorter reauthorization cycle. Only in this manner can Congress be assured that the CFTC will adhere to the directions of this body.

Finally, to prove the adage that it is an ill-wind which blows no good, we will mention one area where we agree with the CFTC's approach. We agree with their assessment that the so- called leverage contracts should be traded only on regulated futures exchanges. In this fashion, these leverage contracts would be on the same footing with all futures contracts and would thus be subject to the same statutory requirements.

CONCLUSION

In conclusion, Mr. Chairman, allow me to go back to the theme with which I began. We represent a large and important institution within a uniquely American industry. Unless the CFTC is mandated by Congress to adhere to the demands of the free market, its restrictive policies will stymie our competitive stance, materially affect our ability to grow, and ultimately force some of our hard-earned business to other market sectors or foreign competitors.

We submit to you that our industry is hostage to an agency that is inexperienced and reacts from fear — fear of public perceptions, fear of criticisms on the part of the press, fear of opinions by other federal agencies or their staffs. We submit that while such matters are of concern, they are not proper motivations for federal regulations or policies.

Our industry has been restrained from changing to meet new market demands and conditions. We are subject to artificial, unjustified limitations on options contracts. We are subject to position limits inconsistent with the needs of commercial market users. We are subject to the wiles of CFTC economists who capriciously rewrite our contract specifications, thus making them less competitive and contrary to industry practices. We are subject to demands based on knee-jerk reactions or motivations based on false or outdated premises. We are subject to operational demands, which, if instituted, will result in inefficient, restrictive and costly trading procedures.

Mr. Chairman, the CFTC must be made to understand that regulation for regulation's sake is wrong at any time but is particularly onerous to the present administration which avowedly follows a policy of deregulation. We respectfully implore that this Committee assist us in these matters.

Statement of John F. Gilmore, Chairman, Board of Trade of Chicago

Mr. Chairman, Distinguished Members of the Committee on Agriculture, Nutrition, and Forestry.

I am John F. Gilmore, Chairman of the Chicago Board of Trade, the world's oldest and largest futures exchange. Joining me is Thomas R. Donovan, our President and Chief Executive Officer.

Although I was elected Chairman only last month, I have been an active participant in the commodity business for two decades. My first job after college was as a livestock analyst for E. F. Hutton. Later I headed their futures operations in Chicago. I am now Vice President of Goldman Sachs and head their Chicago futures operations.

My roots in the commodity business go even deeper. My grandfather was one of the founders of Chicago's Union Stockyards. He and my father were livestock brokers. I am a commodity man through and through, and an unabashed champion of the exchange markets that evolved in Chicago to meet the needs of a growing nation and which today are the envy of the world. And, this success was accomplished notwithstanding the fact that our markets have been regulated by the federal government since 1922.

Mr. Chairman, during the past year these great exchanges have been seriously threatened -- threatened by a series of regulatory assaults, and by an underlying regulatory mentality that all-too-often seems to ignore costs, exalt recordkeeping over market efficiency, and subordinate the vital needs of market users to bureaucratic whims.

And why has the CFTC taken this route? We are told because "public confidence" in our markets needs to be restored.

Yet in 1985 almost 84 million contracts were traded on the Chicago Board of Trade alone -- setting a new annual trading record for the exchange and the U.S. futures industry. This is over 4 times what we traded just 10 years ago.

The facts speak for themselves. Public confidence has never been greater.

I have been cautioned that hearings such as this generally are regarded as ceremonial occasions where ordinary citizens can behave as statesmen and recite platitudes on the virtues of their regulators -- so as not to offend and, hopefully, to curry favor with the regulators.

I would like to, but I am not a statesman. I am a businessman -- a businessman whose business is seriously threatened by a federal regulator. And the fact that the men and women who constitute that regulator are sincere and well-intentioned is no consolation.

So offend I must, if I am to be true to what I believe, and to the thousands of men and women whose livelihoods depend on a healthy, viable Chicago Board of Trade -- let alone the tens of thousands of people throughout the world who must rely on our markets.

One measure of this reliance is the over three billion dollars in futures margin deposits held every night in Chicago banks. A third of these deposits -- one billion dollars -- is from foreign businesses and traders.

Futures markets like Chicago's Board of Trade and Mercantile Exchange are among the things in America that work best. But the threat of over-regulation now jeopardizes this American success story. All this occurs at a time when many foreign exchanges, operating without the heavy hand of government regulation, are primed to take our business away from us. And take that business they will -- unless the CFTC's regulatory assaults are repelled.

Chicago's Board of Trade and the Mercantile Exchange -- the nation's largest futures exchanges, accounting for almost 80 percent of total trade -- recently have been the target of a disinformation campaign of major proportion. The issue, the world is told, is "better audit trails." The CFTC is for them, of course. And supposedly we're against them. The Commission is "boldly moving into the 21st century." We're placed somewhere in the 19th century.

Motherhood, apple pie, better audit trails -- a perfect trinity.

So let's set the record straight.

In the first place, what is an audit trail? An audit trail is the exchange's capability to reconstruct trading activity as a means to supplement market investigations. It is therefore an investigative tool, not an end in itself. The purpose is to ensure the honesty and integrity of all market participants.

So do we support better audit trails as investigative tools? Of course we do. We always have, and always will. Indeed, we presently have an excellent, reliable audit trail, for those who know how to use it. And we are committed to further improvements.

Clearly, the best audit trail is one that utilizes state of the art technology and the know how of the private sector. The best audit trail is one developed by people who trade on futures markets everyday, and who have a personal stake in preserving the markets' reputation for integrity. The best audit trail is one that will enhance our ability to investigate, while preserving our reason for being -- providing liquid, efficient, low cost risk transfer and price discovery markets.

The Chicago Board of Trade and the Chicago Mercantile Exchange have created such an audit trail system. We have submitted the joint system to the CFTC, and last week we presented to the Commission facts and figures supporting our system. To date, the CFTC has refused to "sign-off" on our plan.

Frankly, we suspect they would prefer a system where traders themselves record trade times with pencil and paper. That system is dependent upon a 19th century mentality that a card and pencil are better than technology, and doesn't take into account market disruptions and costs.

Our system relies upon the technology of the 21st century -- computerization of detailed trade information from reliable sources. The CFTC system adopts the unreliable, unimaginative, and out-moded approach.

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All this began some 14 months ago when the CFTC proposed a fanciful mandate that envisioned our traders and brokers wearing some kind of electronic wonder device that miraculously would time all trades as they occur.

Of course, the Commission didn't do any advance research. But we were supposed to do it for them.

And we did. In fact, we hired four leading experts to consider this issue. We commissioned Dr. Merton H. Miller of the University of Chicago and Dr. Sanford J. Grossman of Princeton University to conduct a joint economic study of the costs and benefits of the CFTC proposal.

We hired a leading expert in trading systems technology and design. And, we retained an expert in time-and-motion analysis.

We also went beyond merely studying this matter. While the experts found that the Board of Trade already has an excellent audit trail -- based upon customer order time stamps, Time & Sales data, and 30 minute brackets -- the Board of Trade was not satisfied. We built upon our existing system to improve greatly our audit trail capability through computerization.

All of the expert studies were made available to the CFTC, as were detailed descriptions of our proposed enhancements. We even went to Washington to demonstrate a prototype of our system. We asked for comments, suggestions. We were open to further ideas, of course.

Months passed, but without any dialogue whatsoever. Whatever the Commission was up to was veiled in a web of secrecy. It seemed that our proposition had fallen into a bureaucratic black hole.

And then, on a recent Friday afternoon, this January 10, the Commission unveiled its final rule, along with a 134-page staff brief which left no room for discussion about a better audit trail.

Obviously, we requested a further opportunity for comment -- in light of what we saw to be a doctored record, and the fact that the text of the final audit trail rule differed significantly from the original proposal. We also asked for Commission flexibility, for a willingness to entertain our proposal even on a trial basis.

No way, they said. So just two business days later, on Tuesday, January 14, the CFTC's new rule was adopted.

And the final rule? Read literally, it seemed to mandate one minute trade timing with 100 percent accuracy 100 percent of the time.

As one CFTC Commissioner as well as CFTC staff readily acknowledged, however, no exchange could satisfy the literal mandate. The literal standard is impossible to meet for fast paced open outcry markets where split-second simultaneous executions are commonplace.

Rather than throw up our hands or rush to litigate the issue, we decided to try again to perfect our system to meet the CFTC's demands to the greatest extent possible, without sacrificing market efficiency. We, along with the Chicago Mercantile Exchange, sought a dialogue with the Commission. And we went back to the drawing board to see if we could satisfy the Commission.

A few weeks ago I traveled to the CFTC with the President of our Exchange, Tom Donovan, in an effort to convince the agency to be flexible. We invited the CFTC's Chairman to Chicago to discuss further our program. The Chairman and her staff accepted that invitation and last week received a detailed briefing on the Chicago Board of Trade-Chicago Mercantile Exchange system. Our staffs then came to Washington and gave CFTC staff a two day factual demonstration of the system's capabilities. Despite these efforts, thus far, the CFTC has not found itself willing to accept our proposal.

Let me assure this Committee of one thing. The Chicago Board of Trade and the Chicago Mercantile Exchange are committed jointly to what will be the finest trade surveillance system available.

The system the exchanges have proposed relies upon sophisticated and proven mathematical computations and utilizes state of the art computerized technology. This system complies fully with any reasonable reading of the new mandate the CFTC has given to us.

The CFTC has complained about the nine months it took them to complete an investigation into the 1983 soybean market. They say they were embarrassed when a congressionally promised deadline was not met. Under our system, the 1983 soybean investigation data -- who traded, at what price, at what quantity and when -- could be provided to the CFTC the next day in an accurate, computerized, and usable format.

Yet, the CFTC wants to ride in a "horse and buggy" when we have built a space station. The private sector audit trail solution is more cost-effective, more reliable, more expeditious and less intrusive on the markets than that apparently favored by the CFTC.

The CFTC's recalcitrance has forced us now to petition you to mandate acceptance of our proposed solution. We are therefore asking you to direct the CFTC to vacate its onerous and unreasonable rule and to allow the private sector program to go into effect.

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As my remarks to this point have demonstrated, the Board of Trade's central and immediate concern is relief from the CFTC's audit trail dictates -- either revoke their rule or ensure that the agency will apply it reasonably and fairly by accepting our computerized system. Although it is symptomatic of many of our problems with the agency, audit trails is not the only item on our agenda. We urge --

(1) reform of the CFTC's rulemaking procedures;
(2) a two year CFTC reauthorization;
(3) expansion of and permanent status for the options pilot program including agricultural options;
(4) direction to the CFTC to increase agricultural speculative limits;
(5) a congressional mandate that leverage contracts are futures and must be traded like all other futures;
(6) expedited contract market designation approvals, and;
(7) direction to the CFTC to modernize its hedge definition.

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Audit trails is only one example of a CFTC rulemaking style that verges on the arrogant. Another example is the CFTC's rush last fall to adopt far-reaching changes in CFTC financial requirements for FCMs. These changes were proposed without any concrete analysis of their potential impact. As a result, thousands of industry hours were spent in analyzing untested CFTC proposals, and, in many instances we later learned, specific provisions that the agency staff already had abandoned.

Meaningful comment was made impossible. And to make matters even worse, the time afforded for comment was far too brief.

Fortunately, the CFTC was forced by an unprecedented deluge of public protests to extend the comment period. It now ends early next month.

Each of these protest letters in the CFTC's public file stands as an indictment of the rulemaking practices of the CFTC.

And there is no guarantee that ultimately the CFTC will not adopt many of the more onerous requirements.

Particularly shocking in connection with both of these episodes is the CFTC's utter failure to conduct any cost-benefit analysis. This comes from an agency headed by a professional economist who wrote only five years ago that regulatory programs "should be judged in terms of their costs and benefits."

In our view the need is clear. Something must be done about CFTC rulemaking authority generally, to promote greater responsibility and accountability and to help prevent excessive and misguided regulation. We urge that the Commodity Exchange Act be amended --

First, to mandate that the CFTC conduct and issue a regulatory impact analysis of proposed rules, including an assessment of both the benefits and the costs;

Second, to provide a mechanism for regular congressional review of CFTC rules; and

Third, to modernize the standards and procedures for judicial review of CFTC rules.

The reforms we urge are not novel. Indeed, they have been recognized by regulators, the Courts, and Congress as important tools for improving the regulatory process.

Rather than seeking greater accountability and responsibility for its regulatory programs, the CFTC is taking a diametrically opposite approach. It has asked Congress to insulate the CFTC even further by barring Federal District Court review and independent fact finding regarding CFTC actions, and by mandating that the limited Court of Appeals review which would be allowed must be conducted on the CFTC's made-to-order record. We strongly oppose this measure.

The CFTC's request for virtual carte blanche authority to rewrite the rules of NFA also is unwarranted. Despite the proven record of NFA, the CFTC says it needs plenary authority to rewrite NFA's rules -- and notwithstanding that NFA is a private corporation which relies on not one single cent of tax dollars. The industry has supported NFA to the amount of $46 million since its inception.

The CFTC's rationale for this power grab is the fact that it already has broad authority to rewrite exchange rules. We submit that that power should be checked -- limit CFTC authority over exchange rules; don't increase its power over NFA rules.

In yet another CFTC attempt to obscure its accountability and responsibility, the CFTC has requested an unprecedented six-year reauthorization. Given the CFTC's record of folly and evident appetite for more of the same, we suggest a two-year reauthorization, with a firm commitment to regular interim oversight hearings by this Committee.

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There is one issue where we generally agree with the CFTC -- leverage. The CFTC has proposed that Section 19 of the Commodity Exchange Act be repealed. The result of this would be to require that leverage contracts -- like all other futures contracts -- be traded on regulated exchanges by competitive open outcry.

More specific, direct, and we believe preferable legislation would expressly recognize leverage contracts to be futures contracts and, thus, require leverage firms to comply with all statutory provisions for futures contracts.

One of the requirements for futures contracts is that new contracts must be designated by the CFTC. I regret to report that the Commission continues to drag its feet in processing designation applications. In response to Congress' efforts in 1982 to speed up and modernize this process, the CFTC has designed a marvelous new device for delay -- the infamous "materially incomplete" letter. By a mere letter from any staff member, the Congressional intent to expedite new product approval is overruled. In the meantime, exchanges regulated by the SEC are able to offer new products on a speedy basis.

We urge that further steps be taken to assure that our markets have equal access to new products, by providing for automatic designation of contracts after a reasonable review period.

Another bar to market access is the Commission's hedge definition. Written over a decade ago -- prior to the introduction of interest rate futures and, in particular, stock index futures -- the definition is seriously outmoded. We request that Congress direct the CFTC to review, reconsider, and rewrite that definition to deal with these vital new products.

Ostensibly because of these new products, the CFTC also has proposed legislation to exempt Commissioners and Commission employees from the existing statutory bar against CFTC-insider trading. This potentially far-reaching change in a sensitive policy area deserves careful scrutiny by this Committee.

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Of particular interest to us and this Committee is how to improve our markets for the benefit of American agriculture. We have two specific suggestions. The first concerns agricultural options.

Four years ago Congress (under the leadership of Chairman Helms) wisely lifted the ban on agricultural options and authorized a pilot program on the nation's commodity exchanges. Unfortunately, several years passed before the CFTC put in place its implementing regulations, and trading did not begin until the fall of 1984 -- and only then on a very limited basis. Also unfortunately, the CFTC has continued to see fit to limit severely the number of options that can be traded on any one exchange. The Chicago Board of Trade, for example, has not been able to offer a wheat option.

We have been limited to two options -- soybeans and corn. In 1985 over 840,000 soybean options and over 363,000 corn options were traded on the Chicago Board of Trade. Average daily volume was 3,390 contracts for soybeans and 1,747 contracts for corn.

These are respectable numbers, indicative of viable established markets. Obviously, we wish they were higher, and we will continue in our efforts to make this important new risk-management tool better understood by the U.S. farmer. Already we have conducted 287 programs, distributed almost 900,000 pieces of literature, and spent approximately $3 million in this educational effort.

What is needed now is to lift statutorily the artificial restrictions that the CFTC has imposed, to permit the Chicago Board of Trade and other exchanges to offer options on all agricultural commodities on a permanent basis.

Our second recommendation concerns speculative limits. For 50 years the Commodity Exchange Act has authorized the setting of limits on the number of contracts a speculator may hold or control. Using corn as an example, only once in these 50 years have limits been increased -- 15 years ago, in 1971, from 400 contracts to 600 contracts. These markets now reflect world participation and production; the current limits do not. We strongly believe that increasing limits will make our markets more efficient, particularly in the deferred months where hedging has become very difficult if not impossible.

Our suggestion is that Congress direct the CFTC, within 6 months, to prepare proposed rules for increasing agricultural speculative limits and to submit these rules to Congress for its review, while also soliciting public comment.

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In conclusion, Mr. Chairman, the Chicago Board of Trade is very grateful for having had this opportunity to present its views. They are strong, I know. But a great deal is at stake here.

I know from personal and most painful experience what excessive or misguided regulation can mean. As I mentioned at the outset, my grandfather, Allison Gilmore, helped found Chicago's Union Stockyards. As a young man, alongside my father, I witnessed the slow death of that once great institution. In its last years, there were more regulators in attendance each day than there were people to regulate.

No more, of course. Not a single regulator remains; or anyone else. The Chicago Stockyards is now warehouses and parking lots.

Yes, Mr. Chairman, a great deal is at stake here.

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This concludes my remarks. We respectfully request the opportunity to supplement the record of this hearing with a detailed statement of our positions and our specific legislative recommendations.

Thank you.

STATEMENT OF ALAN J. BRODY
PRESIDENT, COMMODITY EXCHANGE, INC.

Mr. Chairman and Members of the Subcommittee:

I am President of Commmodity Exchange, Inc., popularly known as "COMEX," the world's largest futures and options market in precious metals. COMEX also makes substantial markets in major industrial metals. We accounted in 1985 for 98% of U.S. futures volume in Gold; 96% for Silver; and effectively 100% for Copper and Aluminum. Ranking third among the nation's futures markets, and first in New York City, COMEX has been serving the metals trade for 53 years.

It has now been four years since the activities and operations of the Commodity Futures Trading Commission (the "CFTC") were scrutinized on a comprehensive basis. In those years, there have been major changes in the leadership and staff of the CFTC. The agency's budget has felt the same pressures as other parts of the Federal Government. Meanwhile, futures volume has increased roughly 40%, not counting the commodity option programs that were inaugurated in 1982 and that now add another 20 million contracts per year to the industry total. These strong volume gains, however, mask what has been a deterioration in the profit margins in the futures business as well as a shake-out of many traditional commodity firms that could no longer compete effectively for that business. All in all, the last four years have been good ones for the markets but have not been problem free.

COMEX fully supports the concept of agency reauthorization. Accountability is critically important for a regulator like the CFTC that oversees the delicate machinery of the futures markets and, by dint of its performance, can either enhance or impede the delivery of risk-shifting services to American agriculture and industry. We are pleased to be afforded this opportunity to participate in that process.

The CFTC has recommended a number of changes in the Commodity Exchange Act. In this statement, I will review certain of those proposals and, in particular, the initiative to treat so-called "leverage contracts" like what they really are -- futures contracts. But first, allow me to discuss an event that occurred last year on COMEX that has caused all of us -- the CFTC, COMEX and the industry as a whole -- to raise our guard even higher against the risks of financial problems among commodity firms. I am speaking of the collapse in March 1985 of Volume Investors Corporation ("Volume").

A. Volume Investors Corporation

This development may be the most heavily publicized event to occur in the U.S. futures business for several years. Upon reflection, the level of publicity was not surprising. After all, Volume was the only futures firm to collapse in 1985. That was newsworthy, especially to a press that had grown weary of the litany of insolvencies in other financial sectors -- 120 banks and 57 thrift institutions failed in the same period (nearly 500 savings-and-loans, in fact, are now operating while technically insolvent); and 12 securities broker-dealers were also placed in liquidation. Nor need I mention to this Subcommittee the thousands of family farms and tens of thousands of small businesses that disappeared in 1985. Therefore, while the Volume matter deserves the serious attention that it has received, it remains a tribute to the futures community, including COMEX, that the attendant publicity is in part a response to the rarity of failures in this industry.

As you may know, the Gold futures market was not volatile during 1984 and early 1985. On two days in March 1985, however, dramatic price increases suddenly occurred. Indeed, the $44 (per ounce) jump in Gold futures prices was the greatest for any two-day period in the market's history. At the same time, the premiums paid for Gold options on COMEX increased as much as 700%.

One of the COMEX firms most heavily involved for customers in the Gold market was Volume. While Volume had more than twice the net capital required by the CFTC in the days immediately preceding the dramatic rise in Gold prices, the surge was so great that even Volume's cushion was to prove insufficient, especially when a second event occurred. Three customers of Volume, each a large trader in Gold options, refused to pay margins to Volume in the vicinity of $15 million. These defaults led to Volume's own failure to pay margins to Comex Clearing Association, Inc., a corporation that clears COMEX transactions.

After the default by Volume to the Clearing Association occurred, the firm was restricted by the Clearing Association to liquidating the open positions on its books. A suspension of the firm by COMEX also had the effect of closing Volume to new business after that date. The CFTC itself took action by seeking a court-appointed receiver for Volume and, one day after the default, a receiver was named and took control of Volume's affairs.

An examination of Volume's books disclosed that, as a result of the default, the company had roughly $3.5 million less than would be necessary to reimburse all customers with equity balances as well as most general creditors, despite the injection of $9 million by the Comex Clearing Association.

Immediately, COMEX began a search for sources of funds to satisfy the remaining shortfall. One plan was fashioned in the summer of 1985 between COMEX, the Clearing Association, the receiver, and the two owners of Volume, consisting of $4.1 million toward customer repayment. When a pre-condition to completion of the plan failed to occur on time, however, one owner of Volume withdrew from the program and the fund was reduced by roughly one-half. In a matter of days, the plan was revitalized among the remaining parties, including COMEX which agreed to advance up to $2,850,000 to the receiver to accelerate the pay-out. Court approval of this plan was received last week and a final distribution to eligible Volume customers is now underway. Within days they will receive the full amount of their confirmed account balances.

COMEX is not the first futures market to face the difficulties of a failed firm -- the Chicago Board of Trade, Chicago Mercantile Exchange and the Minneapolis Grain Exchange discovered a problem at the insolvent "Q" Commodities firm some years ago and, because "Q" was a member firm, developed a rescue plan for customers just as COMEX has now done. Thus, while the risk of such an event is historically quite low, it is not a phenomenon limited to any particular exchange or any particular region of the country.

While the Volume situation now appears to be concluding on a positive note, with customers better protected than in nearly any other industry, it has raised a number of broader policy questions about crisis control as well as preventive measures for the future. COMEX has devoted immense time to this subject, recognizing that it cannot be content to simply make customers whole but must also endeavor that customers will not face this problem again anytime soon.

The CFTC has also been assessing the implications of the Volume events, with a view toward regulatory fine-tuning. As you may know, the CFTC had personnel on the scene during the critical period and COMEX kept the CFTC's leadership apprised of what was happening on a continuing basis. Frankly, we are disappointed that the CFTC is now suing COMEX for decisions that it could have easily influenced at the time, but chose to remain passive about. However, that will be resolved in a different forum. Rather, I would like to address here just two of the CFTC's post-Volume regulatory initiatives.

C. Net Capital Requirements for FCMs

After the Volume event, the CFTC proposed to change the net capital requirements for futures commission merchants ("FCMs") so that their resources would have to increase substantially if open market positions at the firm became concentrated in a few hands. As you may know, and as the press has widely reported, the CFTC's first proposal in this regard would have had a crippling effect on FCMs, including some of the largest and most respected grain merchants and financial institutions in the United States. Moreover, the capital changes would not obviate the need for emergency action where positions become concentrated suddenly and unexpectedly. In any event, the CFTC has withdrawn that proposal for further study. We will endeavor to work with the other exchanges, the brokerage community and the CFTC toward a system of financial strength that is effective but not excessive.

D. Customer Account Insurance

A second significant initiative of the CFTC has been to examine a system of customer-account insurance. This is not a new idea. The securities industry has had such a program since the early 1970's under the aegis of the Securities Investor Protection Corp., or "SIPC." The CFTC, at Congress' direction, studied the efficacy of such a program in the mid-1970's and concluded that the loss experience for futures customers was too moderate to warrant the creation of an official insurance system. Even as recently as the CFTC's 1982 reauthorization, the agency reported annualized losses to futures customers of less than $200,000, as contrasted with SIPC's history of about $10 million per year.

Those statistics have not changed materially since 1982. The COMEX-led reimbursement program following the Volume collapse is expected to result in a zero (0%) loss of customer equities. And, even if COMEX and other volunteers had not stepped forward, the annualized customer losses in the futures industry would still have remained very low.

The reason for this low loss rate is the unique system of customer-funds segregation initiated by Congress in 1936. By setting customer deposits apart from the funds available to an FCM for its own use, the failure of a firm has normally left completely intact the money belonging to customers. COMEX supports this segregation program and, looking at the statistics, believes that more study is needed before deciding whether to create and perpetuate a SIPC-type scheme for the futures markets. Would the program's administrative costs alone exceed each year the amount of insurance paid out to customers? If we assume realistically that the program's costs will be ultimately borne by customers in the form of higher transaction expenses, could it become a net detriment to them?

Aside from these considerations, the National Futures Association ("NFA") is completing a preliminary review of the account insurance issue, including an effort to identify the many issues that would need to be answered before final conclusions are reached. COMEX believes, therefore, that it would be premature to express a firm opinion at this time and will await the NFA report and its follow-up before stating an unqualified view on the subject.

Now that the Volume situation is behind us, it is appropriate to direct attention toward a more persistent problem for the futures industry, namely, the purveying of futures contracts under other names by firms that offer neither the self-regulation nor the competitive pricing available on the designated contract markets.

E. The "Leverage Contract" Problem

For over sixty years, federal law has required futures contracts to be traded on government-approved exchanges. In order to obtain approval, exchanges must demonstrate a vigorous self-regulatory capability and must trade contracts that will attract commercial hedgers to their marketplace. All futures contracts that are not traded on exchanges are banned under federal law.

Today two firms are retailing off-exchange futures contracts directly to the public. These aberrant contracts are called leverage contracts. Over the past decade, the firms selling these contracts to the public have waged a largely successful campaign to confuse the public, the CFTC and Congress as to the true nature of a leverage contract. That campaign is now about to end. In the past year, the CFTC, major futures exchanges, and the distinguished chairman of this subcommittee have all agreed that leverage contracts are indistinguishable from futures contracts, as a matter of both law and economics.

The logical legislative response to this conclusion is that since leverage contracts are futures contracts, both instruments should be regulated in the same manner. COMEX joins the CFTC in strongly supporting this legislative approach. COMEX believes, however, that Congress should affirmatively and explicitly mandate that leverage contracts are futures, subject to the same regulation as all other futures, including being traded on designated exchanges. While S. 2045, as proposed by the CFTC, would accomplish this salutary result indirectly, COMEX would prefer to rely on legislation that directly prohibits the off-exchange trading of these contracts, as provided in H.R. 3434. In any event, COMEX and the CFTC fully agree on the end result -- leverage contracts must be treated like all other futures.

As you know, to date the public record on leverage contracts is far from complete. In part, the futures industry is responsible for the lack of public knowledge on this subject.

In past hearings, COMEX and others have not adequately highlighted the serious problems and implications involved in leverage trading. To the extent that our past silence on this issue has been interpreted to reflect indifference, we regret having not fully informed you of our views.

To amplify the record, COMEX, the Chicago Board of Trade and the Chicago Mercantile Exchange conducted a comprehensive study of leverage contracts, which I ask you to include in the official record of this hearing. This extensive legal and economic analysis demonstrates that leverage instruments are futures contracts and represent the most serious threat to the legitimate futures industry that we have seen in a long time.

For more than ten years, a handful of leverage firms have sold their contracts to the public through over-the-counter, off-exchange trading. The resulting toll on the public has become increasingly severe. Millions of dollars of customer funds have been lost through a combination of unscrupulous, abusive sales practices and the financial fragility of leverage firms.

These intolerable public losses could be avoided by recognizing leverage contracts to be futures. The similarities in the two instruments are striking. Both are standardized contracts, calling for the future delivery of a commodity in a specified quantity and quality. The purchase or sale price is agreed upon at the outset. And, the contracts can be satisfied either by taking delivery or -- as is usually the case -- by offsetting a position. Both instruments provide an opportunity to speculate on the future price of a commodity, like silver bullion, with no expectation that delivery usually will occur under the contract. Thus, unmistakably leverage contracts are futures contracts.

The catch is that in leverage contracts the leverage firm both determines the price and then takes one side of every contract. This self-serving feature is in our view what keeps wise and institutional investors out of this market. Our study shows that the price of the commodity in a typical long leverage contract must rise at least 3 times more than in a comparable futures contract, for a leverage customer just to break even. Small wonder that leverage seems to have little interest for any trader but the most naive. As one former CFTC official has been quoted as saying, leverage is a "shell game, in which the company bets that you lose and then makes certain that you do."

Numerous reasons support regulating leverage like all other futures.

First, all off-exchange futures are otherwise prohibited. The sixty-year statutory requirement that futures be traded on an exchange is essential to the regulatory scheme for futures trading. Congress has wisely concluded that futures contracts will serve their important economic purposes -- hedging and price basing -- only when traded under vigorous exchange self-regulation, subject to federal government oversight. Leverage represents an unjustified exception to this longstanding principle.

Second, off-exchange instruments are prone to fraud. In the absence of exchange self-policing, Congress has correctly feared that the public would be subjected to commodity transactions offered by bucket shop operators and con artists. Every recent scandal involving commodity-type instruments and substantial customer fraud has occurred in connection with the offer and sale of instruments not traded on CFTC-designated exchanges (London options in the 1970's; precious metals frauds in the 1980's).

Third, leverage firms have a record of significant fraudulent and unlawful activity. Approximately 11% of all customer reparation claims filed with the CFTC since 1980 have been directed at four leverage firms. CFTC reparation decisions also reflect a long list of adjudicated frauds by leverage firms. The CFTC's enforcement division has brought at least one proceeding against each leverage firm for unlawful misconduct. Thus, leverage represents yet another example of off-exchange commodity fraud that underscores the wisdom of Congress' requirement that futures contracts be traded on exchanges.

Fourth, leverage contracts are purely speculative instruments; no hedgers use leverage. Leverage firms readily admit that no commercial hedgers trade leverage contracts; leverage firms sell their contracts only to speculators. In futures, where hedging is prevalent, speculators assume the price risks hedgers seek to avoid. In leverage, where hedgers do not exist, leverage speculators do not assume price risks for anyone, but merely provide income to the leverage firms. Congress traditionally has expected futures contracts to serve a hedging or economic purpose. Leverage serves none and should not be tolerated.

Fifth, no CFTC rules prohibit leverage manipulation, although all leverage prices are inherently artificial. Leverage prices are fixed by the leverage firms to ensure their profits, not an accurate reflection of supply and demand factors. Exchange-traded futures prices are set by the market, based upon an open and competitive outcry auction. If a futures trader had dominant market power and intentionally used that power to create an artificial price, the CFTC would charge the trader with price manipulation. Under CFTC rules, however, a leverage merchant is free to do this very thing every day.

Sixth, leverage contracts are subject to fewer regulatory safeguards than futures. Before authorizing trading in a futures contract, the CFTC requires an applicant futures exchange to submit to an elaborate demonstration of its ability to regulate trading and the economic purpose of the contract. Leverage firms are not required to make a similar showing, nor could the leverage firms demonstrate any economic benefit to their contracts. Leverage contracts thus enjoy a competitive advantage over futures contracts.

Seventh, the CFTC has neither the resources nor the traditional expertise to regulate leverage. The CFTC's primary regulatory mission is to oversee the self-regulatory programs and operations of the exchanges. Since leverage is traded off-exchange, no comparable self-regulation exists; instead, the CFTC must engage in responsive and burdensome direct regulation that saps the agency's resources. If the CFTC is directed to or decides to lift its moratoria, new firms may flock to the leverage business and further drain the CFTC's limited resources. Although the CFTC's existing leverage rules are well-meaning, the agency's ability to successfully administer and enforce these rules for an expanded leverage industry is, at best, doubtful.

Finally, reported leverage abuses undermine the CFTC's credibility and tarnish the reputation of the legitimate futures industry. Press reports and editorials have recently addressed the public protection problems of leverage. This media attention weakens the CFTC's reputation as an effective regulator and taints legitimate futures trading. Public, and even media, perceptions do not distinguish leverage from legitimate futures contracts.

History, law, economics and logic all point to one conclusion -- special and unequal leverage regulation is no longer acceptable. Congress has always directed futures speculators and hedgers to use exchange markets in order to channel and control their activities under the watchful self-regulatory eye of the exchanges. Consistent with this principle, Congress this year should enact H.R. 3434 to require leverage contracts to be traded under the same rules as all other futures.

In addition to the proposals that emerged after the Volume collapse, and the important leverage issue, a number of other developments and concerns have arisen that deserve mention.

F. Transaction "Audit Trail" Rules

Turning to another subject that has thus far been pursued through administrative regulations rather than congressional action, the CFTC has directed COMEX and the other contract markets to develop a method for recording the execution time of each transaction to the nearest minute. As originally proposed, the CFTC would have mandated a mechanized system of trade-time recordation.

In response, COMEX committed tens of thousands of dollars to a search for on-shelf devices capable of meeting that standard and, as of this date, has found none. Rather, it seems clear that new technology will be required. Accordingly, COMEX has faced two difficult and complex issues. First, could an effective device be designed? And, second, could the device (if even possible) be produced at less than prohibitive cost?

The first challenge -- creating a mechanical timing device -- includes an assessment of the ease of its use, the speed with which it can record the relevant time, and its reliability. A cumbersome, complicated device would invite massive errors. A device incapable of speedy recordation would slow down the rate of trade executions, causing waiting orders to suffer as market prices change in the interim. And an unreliable device would cause chaos when breakdowns occur.

The CFTC did not identify any existing commercial device that could meet those essential needs nor, based on COMEX's research, could it have done so. Similarly, the CFTC did not conduct an analysis of what such a device might cost on a per-unit basis. It remained wholly uncertain whether a manufacturer could or would make the investment necessary to produce such a device for the several thousand floor traders who populate the exchanges. Even if a producer could be found, it was not known whether those devices would cost $100 apiece, or $10,000 apiece.

COMEX, as well as the other contract markets, pointed out these infirmities to the CFTC while, at the same time, registering continued support for the concept of an effective "audit trail." In due course, the CFTC receded from its demand for a mechanical device and agreed to permit any form of time recordation, including the manual entry of execution times. Despite this concession, there continue to be grave doubts whether customers will gain from the final rule.

Specifically, the final rule will cause some new delay in the execution of waiting orders. The duration of each such delay might be debated, but the fact of delay cannot be. The question therefore persists whether the data gained from this additional step in the execution process is worth -- to the customer -- the inevitable and constant risk that trades will not be made at the best prices because of the attendant slow-down in filling their orders.

The CFTC has opined that the protections gained by customers from the new step outweigh the danger of poor executions, while the contract markets are highly dubious. We are not satisfied that the day-in, day-out accumulation of time records on millions of market transactions is really necessary for the CFTC's enforcement program, but may ultimately serve little purpose other than to create another tier of data for economists and academics to ponder.

In our view, the new time-recordation procedure, which is often characterized as a burden only on the exchanges, will need to be judged instead by its burden on customers. In this regard, it is regrettable that the CFTC has not committed itself to any study whatsoever of the possible adverse impact of time-recordation on the very group that is the supposed "beneficiary" of this new requirement. We would urge that such a study be conducted and that, if necessary, Congress so mandate.

G. Duplicative Enforcement Proceedings

The current system of dual regulation in the futures industry, consisting of the exchanges or the NFA in the private sector and the CFTC as the public agency, can give rise to wasteful and even unfair practices. No better example of this phenomenon exists than the duplicative disciplinary actions taken against the same person for the same misconduct by two or more of those prosecuting entities. With too great frequency, an exchange or the NFA charges a member with an offense that, upon conviction (or sometimes despite exoneration), leads to a copy-cat proceeding at the CFTC. Aside from the obvious inefficiency in this system, it impairs the dispensation of justice in a variety of ways.

Consider, for example, the strategy forced upon a potential accused who knows that multiple proceedings are likely to await him. At a minimum, he will have little incentive to settle either contest. He may refuse to give testimony in one setting on grounds that it could incriminate him in the other action (a genuine concern where the CFTC is involved, since the Act contains many criminal provisions). He may seek to delay one of the proceedings, citing the burden of defending himself simultaneously "on two fronts." Or he may fail to provide essential documents because they have already been seized by the other tribunal.

Consider, also, the dilemma presented to the judges in these situations. If found guilty, the offender should receive full and fair punishment. However, knowing that a second round of punishment will be meted out by another tribunal for the same misconduct, it would seem unfair for the judges to impose a full measure of discipline. Accordingly, justice is dispensed with one eye on the next proceeding that the accused must face. Conversely, the judges in the second proceeding may find it necessary or appropriate to re-shape their findings or penalties in light of what the first tribunal did. In short, the disciplinary process becomes confused if not confounding, for accused and accuser alike.

While it is true that, under futures regulation, the exchanges and the CFTC have somewhat different disciplinary powers available to them (for example, an exchange can expel an errant member from that market alone while the CFTC can bar him from all markets either temporarily or forever), there are common forms of discipline such as fines or, under CFTC rules, "civil penalties" where some rationalization of the process is possible. Another example might be the action taken by an exchange against a floor broker in which he is suspended from floor privileges, while the CFTC imposes the same restriction by suspending his floor broker registration. Coordination of penalties is possible and proper in these circumstances, and yet the CFTC seems little interested in doing so.

COMEX supports a system of cooperation between the self-regulatory bodies and the CFTC to avert the manifest injustice and profligate inefficiency of the present duplicative enforcement programs. In 1982, Congress admonished the CFTC to better coordinate its enforcement efforts with the disciplinary programs of the self-regulatory bodies, but little progress has occurred. We urge Congress to direct the CFTC once again to rectify this problem, either by unequivocal expression in the Act or clear mandate in the legislative history of this reauthorization.

H. Cost-Benefit Analyses

It is a principal failing of federal regulation generally, and of CFTC rulemaking in particular, that no burden or obligation is formally placed on the agency to demonstrate that the cost to the public of new regulatory programs is more than offset by the benefits that will inure from those initiatives. A case in point was the CFTC's audit trail proposal that would have mandated a mechanical time-stamping system without regard to what its current costs might be or whether its development as new technology would be prohibitively expensive.

COMEX believes that the CFTC should be required to conduct a cost-benefit analysis before adopting significant regulatory programs. In addition, good management dictates that on-going programs should be re-assessed from time to time on a cost-benefit basis to determine whether they are (or ever were) worth the expense. Returning to the audit trail example, the CFTC should be put to the duty of studying whether the costs that customers will surely incur through delayed order executions under the CFTC one-minute recordation program exceed the quantifiable benefits of this new system. Not only has the CFTC failed to include that important analysis in its final rule, but appears to have been oblivious to its value.

I. The Options "Pilot" Program

Beginning in August of 1982, the CFTC re-introduced commodity options trading on the nation's contract markets. While embellishments have been made since then, the "pilot" status of the program has remained unchanged since that date. This, even though the CFTC had announced that the pilot phase would end in October of 1985. And this, despite a nearly spotless record for the options program since its initial introduction.

The CFTC's reluctance to adhere to its own cautious deadline for the pilot stage of the options program is mystifying to us. The collapse of Volume in March 1985 -- discussed earlier -- did not give cause to question the integrity or soundness of the revived options markets. On the contrary, approximately 20 million options per year are traded on the contract markets -- the equivalent of all futures trading in 1972 -- without fraud or scandal.

COMEX has urged the CFTC to proceed with the options program free from the onerous "pilot" restrictions, but our efforts have been unavailing. Congress should not permit the CFTC to be dilatory in its handling of the options program. It can be operated at this time under normal regulatory conditions without public peril, and it should be.

J. CFTC Re-Write of NFA Rules

COMEX cannot agree with the Commission's desire for power to change NFA rules unilaterally if it deems that revisions, additions or deletions are needed. While it is correct that the CFTC has authority in the case of contract markets to alter or supplement their rules under certain limited circumstances, it does not follow that such should be the case for the NFA. The NFA does not deal, for example, with market-wide emergencies where inadequate rules could exacerbate a market crisis and where, to avert that consequence, the Commission can take steps in advance to compel that relevant contract market rules be revised.

Moreover, the NFA has proven itself to be a responsible and responsive self-regulatory body, as the CFTC itself has found. Until such time as the CFTC can demonstrate an uncooperative attitude at the NFA toward considering rule changes suggested by the CFTC, there will be no need for the CFTC to assert absolute power over the contents of those rules.

K. Period of CFTC Reauthorization

As stated earlier, COMEX favors the reauthorization process as an effective way to assure accountability of federal agencies like the CFTC. Otherwise, they might labor in relative obscurity for many years, going about their highly technical work with little or no public review.

Since the creation of the CFTC, the reauthorization cycle has been four years: 1974 (creation), 1978 (review) and 1982 (review). This interval seems well suited to the meaningful evaluation of the CFTC's performance. Old programs are given a 4-year "check-up" while newer programs are reviewed after an appropriate testing period. A longer hiatus -- such as the 6-year cycle proposed by the CFTC -- would leave poor policies in place too long. Accordingly, COMEX urges that the existing 4-year reauthorization cycle be preserved for the CFTC.

Conclusion

Mr. Chairman and members of the Subcommittee, COMEX commends you for the diligent oversight that the CFTC has received in the past, and for the continuation of that tradition in these hearings. The problem of Volume Investors Corporation is behind us, with no customer losses. The important question of whether futures trading -- even if called "leverage" -- should remain on the self-regulating, competitive exchanges has properly been raised and should be answered in the affirmative. As for other issues, our positions have been stated above. With your help, the CFTC will become an improved agency sensitive to the costs of its initiatives, the human hardships that duplicative discipline inflicts, the need to act in a decisive way on such matters as the options program, and the importance of tailoring its demands -- whether capital requirements, audit trail or other proposals -- to what can realistically be done.

THE TRUTH ABOUT LEVERAGE, STUDY BY THE CHICAGO BOARD OF TRADE, CHICAGO MERCANTILE EXCHANGE, AND COMMODITY EXCHANGE, INC., MARCH 20, 1985

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THE TRUTH ABOUT LEVERAGE

Introduction

For more than sixty years, Congress has required that futures contracts be traded on designated exchanges, in the well-founded belief that off-exchange trading encourages boiler room and bucket shop operators and otherwise undermines legitimate futures trading. Since 1974, Congress and the Commodity Futures Trading Commission[1] have struggled to reconcile these well-settled principles with the amorphous instruments known as "leverage" contracts.

During this decade, firms offering leverage contracts have justified congressional suspicion of off-exchange futures trading by engaging in adjudicated unscrupulous and abusive sales practices against public customers. A potential flood of further abuses has been stemmed only by CFTC moratoria on new leverage firms and commodities that can be the subject of leverage contracts.[2] As the result of perceived congressional action in 1982, however, and despite serious Commission reservations as to whether its action was sound public policy, the CFTC adopted regulations in 1984 and early 1985 that purport to legitimize both long and short leverage contracts and subject them to comprehensive regulation.[3]

A complete, well-documented public record on leverage has never been developed. To fill this gap, an extensive examination has been conducted of the leverage contracts being offered to the public, the statements of leverage merchants in various forums, the history of abuses in the leverage industry, and the regulatory scheme and policy considerations concerning leverage trading. This study yields some troublesome conclusions:

1. Leverage contracts are futures contracts, as the chairman of one leverage firm admitted in 1974.[4] Leverage contracts are standardized agreements for the future purchase or sale of a commodity, in a specified quantity and quality, at a price agreed upon at the time the agreement is made. A customer can satisfy a leverage contract by making or taking delivery of the commodity, but generally expects to offset contractual obligations before delivery and accept net profit or loss as of the date of offset. Leverage instruments thus bear all of the classic indicia of futures contracts.
2. Off-exchange leverage trading violates Congress' sixty-year requirement that futures contracts must be traded on designated exchanges.
3. Leverage contracts serve no economic purpose; no commercial hedging in leverage contracts exists or is required.
4. Leverage contracts have a built-in conflict of interest, since the leverage merchant both sets the price of each transaction and is a principal to every contract.
5. The present regulatory scheme for leverage is inadequate to remedy the structural defect of off-exchange trading and the inherent conflict-of-interest in leverage contracts. These structural problems cast doubt on the CFTC's ability to protect the public adequately even under extensive

regulations, particularly by direct regulation rather than in its more familiar oversight role.

6. Present leverage regulation hurts the legitimate futures markets. Not only do off-exchange scandals scar public confidence in legitimate futures trading, off-exchange trading of leverage contracts is subject to fewer regulatory protections than futures contracts.

Permitting leverage contracts to be marketed as off- exchange futures contracts threatens to become the exception that will swallow the historic congressional rule that futures contracts must be traded on designated exchanges. Any lifting of the leverage moratoria under the existing regulatory scheme would present con artists and boiler room operators a ready-made haven for further public abuses by encouraging them to purvey futures contracts (disguised and labeled as leverage contracts) over the counter. Congress has never sanctioned off-exchange, noncompetitive over-the-counter futures trading because of just such risks. Congress must act now to make clear that leverage contracts are futures contracts that must be traded on designated exchanges and that must comport with all other requirements applicable to futures contracts.

I. Description of Leverage Contracts

The leverage industry sprang up in the 1960's and early 1970's as public interest in precious metals rose in the United States.5/ Leverage merchants have garnered more than $8 billion in revenues since that time.6/ Nevertheless, from 1973 to 1977 at least eleven leverage firms failed, leaving $17.5 million or more in customer losses.7/ At least three leverage firms presently qualify to remain in business under the CFTC's 1978 and 1979 moratoria on new entrants to the field.8/

The term "leverage contract" is not defined in the Commodity Exchange Act (CEA or Act).9/ Section 19(a) of the Act10/ refers to transactions for the delivery of certain commodities under "a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract." The statutory reference to the "trade" is somewhat mysterious since when Congress first enacted leverage legislation in 1974,11/ such contracts were neither well known to the commodities markets nor to Congress itself.12/ Leverage contract terms traditionally have differed from merchant to merchant, and any individual merchant most likely has offered different contracts over the years.13/ However, certain basic characteristics of leverage contracts can be identified.

The definition of a leverage contract offered in Congressional testimony by the president of one leverage firm14/ is, albeit incomplete, one with which other leverage merchants agree:15/

> [A] leverage contract is best described as a standardized agreement for the purchase from or sale to a member of the general public of a specified commodity in a standard unit and quality for delivery at any time upon payment

> in full. The principal characteristics of leverage contracts include: (1) standard units, quality, and terms and conditions; (2) payment and maintenance of margin; (3) payment of carrying or leverage charges on the unpaid balance of the purchase price under the contract, which payments may vary and be paid periodically, or be fixed in advance and prepaid for all or a portion of the term of the contract; (4) close-out by an offsetting transaction or by delivery, after payment in full; and (5) no right or interest in a specific lot of the underlying commodity until delivery.
>
> The leverage dealer is the principal to every such transaction and functions as a market maker. Leverage dealers cover their obligations to their customers by maintaining physical inventories and by engaging in transactions in the cash forward and futures markets.16/

The definition of a leverage contract in the CFTC regulations generally incorporates this description.17/ Comments by various leverage merchants, as well as congressional and other studies of leverage, however, provide some qualifications and explanations of the elements of this definition as well as the mechanics of leverage trading.

A. Standardized Agreement; Standard Units, Quality, and Terms and Conditions.

The leverage merchant standardizes the contracts offered to customers.18/ The terms and conditions of many leverage contracts are subject to change at the sole discretion of the leverage merchant, and merchants often have had discretion to demand that the customer pay in full or make delivery at any time.19/ For example, in one leverage firm's contract filed with the Commodity Futures Trading Commission, no less than eleven contract terms were listed as subject to change without notice, including opening and closing commissions; the time period allowed for delivery of or payment for commodities purchased and sold; ask and bid differential, that is, the difference between the price for which it would sell a contract and the price for which it would buy the same contract; delivery requirements; and commodities accepted by the merchant.20/ The contract also contains an apparently common caveat that the merchant does not guarantee that it will maintain its market with its customers to buy and sell the commodity.21/

B. Purchase From or Sale to a Member of the General Public.

Leverage merchants admit that leverage transactions were not designed to be used and are not in fact used by commercial enterprises as hedging vehicles or otherwise.22/ In fact, leverage merchants claim that Congress has made clear that leverage transactions need no economic justification at all; in their view it is sufficient that leverage transactions allow public customers to speculate in price changes in precious metals in order to "hedge against inflation."23/ Whether precious metals constitute effective inflation hedges is, of course, a greatly disputed economic theory.24/

C. Purchase or Sale of a Specified Commodity.

Leverage transactions to date have primarily involved transactions in silver and gold bullion and bulk coins. Other precious metals and foreign currency have also been the subject of leverage transactions.25/ The customer who signs a leverage contract agrees to buy from or sell to the merchant the specified commodity within a certain time period, ten years or more under the CFTC rules.26/ The merchant takes the other side of the customer's position, agreeing to sell the commodity to the customer or buy the commodity from the customer, as the case may be.27/

Although in early 1984 the Commission expressed doubt as to whether leverage merchants traditionally engaged in "short sales," that is, transactions in which the customer agrees to sell a commodity to the merchant,28/ leverage merchants assured the Commission that they had indeed offered such short contracts.29/ Due to perceived congressional intent, the Commission has decided to permit short leverage contracts.30/

D. Leverage Dealer as Principal in Customers' Contracts.

No contract market or board of trade is involved in leverage transactions,31/ despite the contrary representations of some leverage merchants.32/ Leverage commodity prices are quoted by the merchant;33/ there is no open outcry or competitive price setting mechanism.34/ In fact, CFTC rules now require the leverage price (the bid-ask spread) to be set unilaterally by the merchant.35/

A CFTC administrative law judge succinctly described most merchants' pricing of leverage contracts:

> The basis for [the firm's] pricing is also a mystery. There is no precise formula related to any public documents which will permit an objective reconstruction. [The firm's] prices are simply what [the firm] says they are or were.36/

E. Margin; Carrying or Leverage Charges.

A customer entering a "long" leverage transaction, that is, one in which the customer agrees to purchase the commodity from the merchant, must put up an initial "margin" (generally 20-25% of the contract price); the customer entering a short transaction also must pay a margin or deposit.37/ Over the life of the contract the customer remains subject to various charges and margin requirements. The charges may include an "opening commission";38/ leverage or interest charges on the unpaid balance of a long contract;39/ a fee for the customer to change from paying variable to paying fixed interest;40/ a closing commission on contracts that are offset;41/ assaying fees;42/ premiums if delivery is made on certain quantities of the commodity;43/ and delivery charges on contracts on which delivery is made or taken.44/

Margin, deposits, or account equities generally must be maintained at certain levels throughout the life of the contract as set by the leverage merchant.45/ The required margin levels usually are subject to change at the discretion of the leverage merchant.46/

F. Closeout by Offsetting Transaction or Delivery.

"Offset" is used among leverage merchants to describe the process by which the merchant relieves the customer from his obligation to make or take delivery of the commodity.47/ Studies of leverage merchants to date have found that at least nine out of ten leverage contracts never result in delivery because customers offset their leverage positions or fail to make required payments.48/

The average period that leverage contracts actually remain open is a matter not commonly discussed publicly by leverage merchants. Indications are, however, that the average duration of leverage contracts is less than one year.49/

G. "Cover" of Customer Obligations.

Until recently there was no requirement that leverage merchants cover their obligations to customers by maintaining inventory of the physical commodity or acquiring futures or forward contract positions in the commodity.50/ Some leverage merchants have maintained some degree of "cover,"51/ but, as Congress has recognized, these merchants' physical inventories are generally subject to bank liens.52/ Cover of customer positions in a specific commodity has often been maintained by the merchant not in that specific commodity, but in other commodities termed "price related" by the merchant.53/ At least one major leverage firm was found by a Commission administrative law judge to have "permitted customer positions to stand 'naked' for intervals, and at one time . . . had no positions in the futures market."54/

II. Leverage Contracts are Futures Contracts

A. Comparison of Leverage Transactions and Futures Contracts.

As the chairman of one leverage firm admitted in 1974, leverage contracts are a "form of contract for future delivery."55/ Leverage contracts embody all of the fundamental elements of futures contracts. This conclusion is grounded firmly in judicial and CFTC precedent and congressional intent.

The Commodity Exchange Act does not define the term "futures contract" expressly. Instead, the Act often describes futures contracts with the phrase "contract of sale of a commodity for future delivery."56/ From this purposefully broad statutory language, several basic elements of a futures contract have evolved. These elements include the following:

> (1) a standardized agreement for the future purchase or sale of a commodity;
> (2) a provision for future delivery of the commodity in a specified quantity and quality;
> (3) a purchase or sale price agreed upon at the time the contract is executed;
> (4) satisfaction of the contract by making or taking delivery or through cash settlement;
> (5) satisfaction of the contract, in the alternative, by offset, in essence a liquidation of contractual obligations prior to the delivery date and acceptance of net profit or loss as of the date of liquidation; and
> (6) the general expectation of the parties to the contract that it will be liquidated by the offset process rather than by delivery.57/

The CFTC has found that these six elements are the classic indicia that an instrument is in fact a futures contract.58/ Essentially, therefore, a futures contract provides an opportunity to enjoy a profit or loss tied to the future value of a commodity without expectation that delivery of the commodity will occur under the contract.

In these respects leverage contracts are identical to futures contracts. The contracts for sale of the commodity are standardized--standardized by the merchant in leverage transactions and by exchanges in traditional futures transactions. The price term, which is not standardized in either type of contract, is established at the outset of both leverage and futures transactions. Margin payments are required to establish and maintain leverage and futures contracts. Each type of contract can be satisfied by the customer's making or taking delivery of the commodity. In the vast preponderance of cases, parties to both futures and leverage contracts anticipate that the agreements will be offset. Whether this offset involves taking an opposite position, as in exchange-based futures trading, or release from or resale of a position, as in leverage trading, the parties take their net gain or loss at the time of offset as reflected in the price differential between *their original contract and the offsetting* transaction.

B. Examination of Judicial Precedent.

Not surprisingly, leverage contracts bear a remarkable resemblance to other instruments that courts have found to be futures contracts. In CFTC v. Co Petro Marketing Group, Inc.,59/ the merchant unilaterally set the "motor vehicle fuel" contract prices and established a degree of contract standardization. Customers generally offset their commodity purchases and did not take delivery of fuel; the contracts were not traded on a commodity exchange.60/ The court had no difficulty finding that the merchant was offering an unlawful off-exchange futures contract.61/

Standardized "coal purchase contracts" were found to be futures contracts in CFTC v. National Coal Exchange, Inc.62/ Customers had no intention or expectation of taking delivery of the commodity but intended only to speculate in coal price changes.63/ The fact that the merchant had orally assured customers of an offset possibility was sufficient in the court's view to make the agreement a futures contract.64/

In an enforcement action brought by the CFTC, an administrative law judge found in 1983 that so-called "forward contracts" offered by two of the major leverage firms were futures contracts unlawfully traded off exchange.64/ These were standardized contracts for the purchase or sale of gold, silver, or currency commodities, with a 15-month contract term and a provision for delivery or offset. The judge found that the contracts simply provided the general public "an opportunity to speculate on price changes in commodities,"66/ and that such contracts were required to be traded on exchanges under federal law.67/ Remarkably, the firms argued before the ALJ that these off-exchange futures contracts were leverage contracts,68/ and in subsequent disclosure documents one firm denominated its forward contract as one of its "leverage programs,"69/ even though the Commission had by then determined leverage to be contracts of ten-year duration or longer.70/ The ALJ's decision is on appeal to the Commission.

This precedent, which includes an examination of certain leverage products, illustrates that leverage contracts are futures contracts as a matter of law, and that enforcement of the requirement that futures contracts be traded on designated contract markets is possible only when the law "[d]isregard[s] form for substance."71/

C. Irrelevant Differences Between Leverage and Futures Contracts.

Some have attempted to distinguish between futures and leverage by describing leverage contracts as installment purchase agreements.72/ A more sophisticated version of this claim characterizes a futures contract as a present agreement to contract in the future for the sale or purchase of a commodity, and describes a leverage contract as a present agreement to sell or purchase a commodity with delivery simply deferred until the future.73/ These arguments attempt to cast leverage in terms of a so-called cash forward contract, which as a "sale of a[ ] cash commodity for deferred shipment or delivery" would fall outside the statutory definition of a futures contract and, indeed, would not be subject to regulation under the CEA.74/

These distinctions are inherently flawed and contradict the leverage firms' own definition of leverage. In contrast to the "present agreement to buy or sell" theory described above, the leverage firms have conceded that a leverage customer, like a futures customer, has no right or interest in a specific commodity until delivery. Moreover, leverage contracts, like futures contracts, predominantly do not result in delivery of the commodity.75/ Nor do the parties to a leverage contract anticipate that delivery will occur routinely. In contrast, a cash forward contract is basically distinguished from a futures contract by the parties' expectation that delivery of the commodity will occur.76/

To be sure, leverage contracts contain certain idiosyncratic terms not found in exchange-traded futures contracts. These special features do not detract from the dominant themes and purposes of a leverage transaction, which are identical to those of a futures contract. Indeed, these aspects of leverage contracts reflect little more than a cosmetic attempt to disguise a futures contract as leverage in the hope of avoiding statutory requirements.

For example, a leverage customer may take delivery of the commodity by paying the entire contract price at any time after the contract is signed until the contractually specified delivery date.77/ In a futures contract, delivery under the contract occurs generally in a specified delivery period. This difference, however, is without economic or legal significance, again because customers in large part do not take delivery of leverage-contract commodities.78/ Moreover, it is now well recognized that delivery of a commodity need not be required at all under a futures contract; since 1981 the CFTC has been approving so-called deliveryless or cash-settled futures contracts.79/

Another irrelevant difference is that individual leverage contracts may involve smaller quantities of a commodity than some futures contracts.80/ The size or quantity of a commodity has never been found to be a meaningful element of a futures contract. Futures trading occurs in many commodities in different quantities on various exchanges. Some leverage merchants also point to the fact that the nominal duration of a leverage contract is generally longer than that of a futures contract.81/ However, one leverage merchant has conceded that the length of the durational term is "not definitionally relevant,"82/ an inescapable conclusion, since most leverage contracts terminate long before their final delivery date.

One significant difference exists between leverage and futures contracts--where each contract is traded. Unlike futures contracts, no contract market or board of trade is involved in leverage. As a result, no clearinghouse matches customers' trades; no open-outcry, competitive system establishes prices; and no economic purpose or commercial need is required for a leverage contract. It begs the question, however, to argue that a leverage transaction is not a futures contract because it is not traded on a designated contract market. Contract market oversight promotes honest dealings and protection of the public, but "the requirement that a futures contract be executed on a designated contract market is what makes the contract legal, and not what makes it a futures contract."83/

III. Inherent Potential for Fraud and Other Abuses.

Because leverage contracts are indistinguishable from futures contracts, the manner in which they are presently structured and regulated makes them inherently susceptible to fraud and other abuses. Over-the-counter trading of leverage instruments contravenes Congress' repeatedly reaffirmed view of the past sixty years that dangers to the public of off-exchange futures contracts are unacceptable; and the lack of any public interest or economic purpose requirement for leverage contracts legitimizes mere speculation in commodity price fluctuations. The leverage merchant's role as principal on one side of every contract and the merchant's unilateral determination of the price term create an inherent conflict of interest in these transactions. Moreover, terms and conditions of the contracts themselves, which have not improved materially under the new CFTC regulations, make it difficult for the leverage customer just to break even on a contract.

A. Violation of Exchange-Trading Requirement.

Leverage contracts do not comport with the longstanding congressional policy that futures contracts must be traded on designated exchanges. This congressional mandate first appeared in the Future Trading Act of 1921, in which Congress imposed a steep tax on futures contracts not traded on government-approved contract markets.84/ After the Supreme Court found this tax unconstitutional,85/ Congress imposed an outright prohibition on futures trading that was not conducted on a designated contract market.86/ This requirement has been perpetuated in the Commodity Exchange Act, which presently makes explicit that "[i]t shall be unlawful for any person . . . to enter into . . . a contract for the purchase or sale of a commodity for future delivery . . . unless such transaction is conducted on or subject to the rules of a board of trade which has been designated by the Commission as a "contract market" for such commodity . . . ."87/

The reasons for this requirement are numerous. Congress imposed exchange trading of futures contracts primarily to combat and eliminate off-exchange bucket shop operations.88/ Congress expressed its intention to ban all "bucketing" of customer orders,89/ which included transactions in which a broker took one side of a customer's order rather than executing the order through an exchange.90/ The following colloquy among Congressmen on the floor of the House of Representatives makes this clear:

> Mr. Williamson: Will this bill put an end to local bucket shops over the country? . . .
>
> Mr. Purnell: Yes, it will, because the men who buy under the present bucket-shop system will not have any place to buy unless they do business through a [designated] contract market. . . .
>
> Mr. Voigt: The bucket shop is wiped out in this bill, because a bucket shop is not a contract market.
>
> Mr. Purnell: The gentleman is exactly right. . . . 91/

A competitive, open-outcry auction system for establishing the price of commodity futures contracts, and thus of the underlying commodities, has also been a congressionally recognized element of futures trading that is crucial to protection of market integrity and promoting the national and international economic benefits of accurate price discovery.92/ Only in futures transactions denominated as leverage do merchants have the discretion to establish contract prices in a blatantly noncompetitive or anticompetitive manner.

The Commodity Exchange Act reflects congressional efforts to regulate futures trading through vigorous self-regulation by exchanges, with the federal government serving an additional oversight function. This scheme has worked well in implementing Congress' mandate that exchange trading is necessary to promote market integrity and ensure public confidence in the markets.93/ The contract-market designation requirement enables the CFTC to require that exchanges have a significant capability to police trading in futures contracts in order to deal in any such contracts.94/ None of the safeguards of exchange trading are present, of course, in leverage transactions.

B. Violation of Economic Purpose and Public Interest Requirement.

The value and commercial necessity of futures trading is now unquestioned, and Congress permits only futures contracts that serve a price-discovery or hedging function.95/ Congress thus has required that boards of trade proposing to trade futures contracts demonstrate that these contracts not be "contrary to the public interest."96/ This broad requirement has been interpreted consistently to require that commodity futures contracts have an economic purpose, a hedging or price-discovery function beyond mere speculation in commodity prices.97/

Leverage contracts have become a disturbing exception to these important rules. One CFTC Commissioner summed up the problem as follows:

> Leverage transactions appear to function principally as speculative vehicles. They do not serve the risk shifting and price determining

> functions traditionally associated with exchange traded futures contracts.98/

Leverage merchants have almost gleefully announced to the CFTC that leverage transactions are not and need not be "imbued with a public interest."99/

C. Inherent Conflict of Interest.

Leverage customers, in effect, are forced to play blackjack with a dealer that determines unilaterally which cards are to be dealt the customer. Leverage merchants both set leverage contract prices and act as a principal to each transaction. This pricing mechanism creates an inherent potential for fraud because it may be unprofitable in many instances for the merchant if the customer makes a profit.

One leverage agreement in use in 1984 was unusually candid about this conflict of interest as it concerned one aspect of the overall problem. This particular contract allowed the merchant to refuse to execute purchases from and sales to a customer pursuant to the customer's trading instructions, even though the contract permitted such "stop order" instructions.100/ "[I]n such transactions," the contract read, "a potential conflict of interest exists between [the merchant] and its customers."101/ In any number of other situations, a leverage customer's gain can be a merchant's loss.102/

D. Unfavorable Contract Terms.

Leverage transactions, by their very nature, impose on customers various fees and carrying charges not present in traditional futures contracts. Leverage contracts also have traditionally allowed merchants to change numerous contract terms and conditions at their discretion and to demand immediate payment in full or delivery. These features, which have been described above, have made it inherently difficult for leverage customers to make a profit.

According to a CFTC staff comparison of two long silver- bullion leverage contracts and an exchange-traded long silver-bullion futures contract, the price of the underlying commodity would have to increase by 17.26% and 21.40% for the two leverage contracts, respectively, in order for the leverage customer to break even in one year.103/ The comparable futures contract would only require a 14.3% commodity price increase to achieve a break-even point.104/ These findings are summarized in Table 1. These figures, however, do not disclose the problem fully. As the CFTC staff agrees, many leverage contracts remain open for much less than one year.105/

Carrying charges and front-loaded fees make a leverage contract held open for a period shorter than one year remarkably less advantageous than a futures contract held open for the same period. The CFTC staff's assumptions about prices, fees, and carrying charges can be used to calculate break- even figures for the same two leverage contracts and the same futures contract under an open-contract period of one month. Under this scenario, detailed in Table 2, the underlying commodity price would have to increase by 7.28% or 8.79% during the month for the customer to break even on the respective leverage contracts; these are equivalent to annualized percentage increases of 87.36% and 105.48%, respectively. In the futures contract, the commodity price would only have to increase by 2.63% during the month to reach the break-even point, an annualized percentage rate of 31.56%. The percentage increases necessary for a customer to break even in leverage thus can be 3 to 3.3 times greater that those necessary to break even in futures trading.

TABLE 1 - Break-Even Calculations For Long Leverage And Futures Contracts Initiated on July 2, 1984 And Left Open For One Year And Then Offset a/

Commodity = 1,000 ounce bar of .999 fine silver bullion

	Monex Leverage Contract	IPMC Leverage Contract	CBT Futures Contract	b/
Ask Price	$8,385 c/	$8,531 c/	$8,380	c/
Bid Price	$8,195 c/	$8,280 c/	$8,280	c/
Initial Charges	$167.70	$298.59 d/	$70	e/
Carrying Charges	$893.00 f/	$1,330.89 g/	$1,175	h/
Interest on Margin	-	$191.24 i/	$121	j/
Bid Ask-Spread	$190.00	$251.00	$60	k/
Price to Break-Even Excluding Termination Charges h/	$9,445.70	$9,969.24	$9,464	
Termination Charges	$163.90	$82.80 d/	-	m/
Total Price to Break-Even	$9,609.60	$10,052.04	$9,464	
Percentage Price l/ to Break-Even	17.26%	21.40%	14.30%	
Initial Margin	$1,677	$1,706.20	$1,000	

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a/ Based on current fee schedules, which are subject to change. Initial charges and termination charges are the equivalent of brokerage commissions on futures contracts.

b/ Since the initial contract price on a leverage contract is equivalent to a spot price and carrying charges are then assessed separately, the price of the August 1984 future is used as the initial contract price and the carrying charges are those implicit in the difference between the nearby futures price and the one-year deferred futures price.

c/ The Monex bid and ask prices are for 5:00 p.m. Eastern Standard Time (EST) on July 2, 1984 and the IPMC quotes are for 4:00 p.m. (EST) on July 2, 1984. The bid and ask prices for the CBT futures contract are based on the settlement price of the August 1984 future on July 2, 1984 and traders' estimates of a $100 bid-ask spread in the futures market for a futures contract with a one-year maturity. More specifically, the ask price is equal to the futures settlement price ($8,330) plus one-half of the bid-ask spread (1/2 x $100 = $50) and the bid price is equal to the futures settlement price ($8,330) minus one-half of the bid-ask spread ($50).

d/ IPMC uses a sliding scale for initial and termination charges that is based on the transaction price.

e/ This is equal to a representative round-turn commission on a futures contract.

f/ Monex assesses carrying charges on the unpaid balance at the current rate of 12½% per year compounded daily (13.3% effective annual rate).

g/ IPMC also assesses carrying charges on the unpaid balance at the current rate of 14.5% per year compounded daily (15.6% effective annual rate).

h/ The carrying charges for the futures contract were obtained by subtracting the settlement price of the August 1984 future ($8,330 per contract) from the settlement price of the August 1985 futures ($9,505 per contract) or an effective annual rate of 14.02%.

i/ IPMC credits a customer's account with interest on their margin deposits; however, this interest rate is usually lower than the rate IPMC charges the customer - e.g., an interest credit of $191.24 that is based on an 11.2% effective annual yield on the margin deposit, which in this example is $1,706.20 or 20% of $8,531.

j/ U.S. Treasury bills may be posted as margin on futures (at an effective annual yield of 12.14% in this example). If traders do not post Treasury bills or receive an interest credit from their broker then this amount would have to be added to the Total Price to Break-Even on the futures contract.

k/ Traders estimated the bid-ask spread for the nearby month to be $20 and for one year out to be $100. Therefore, total bid-ask spread would be $60, or 1/2 of the far spread of $100 plus 1/2 of the nearby spread of $20.

l/ Based on the bid price of the contract.

m/ The full round-turn futures commission was included in the initial charges.

TABLE 2 - Break-Even Calculations for Long Leverage and Futures Contracts Initiated on July 2, 1984, Left Open for One Month, and then Offset

Commodity = 1,000 ounce bar of .999 fine silver bullion

	Monex Leverage Contract	IPMC Leverage Contract	CBT Futures Contract
Ask Price	$8,385	$8,531	$8,340[b/]
Bid Price	$8,195	$8,280	$8,280
Initial Charges	$167.70	$298.59	$70
Carrying Charges	$74.42[a/]	$110.91[a/]	$97.92[a/]
Interest on Margin	-	$15.94[a/]	$10.08[a/]
Bid Ask Spread	$190.00	$251.00	$60
Price to Break Even Excluding Termination Charges	$8,627.12	$8,924.56	$8,497.84
Termination Charges	$163.90	$82.80	-
Total Price to Break Even	$8,791.02	$9,007.36	$8,497.84
Percentage Price to Break Even (Monthly)	7.28%	8.79%	2.63%
Annualized Percentage Price to Break Even	87.36%	105.48%	31.56%
Initial Margin	$1,677.00	$1,706.20	$1,000.00

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a/ Estimated by taking one-twelfth of CFTC annual calculations.

b/ Corrected from CFTC calculations. With a bid price of $8,280 and a bid-ask spread of $60, the ask price must of necessity be $8,340.

A study submitted to the CFTC by one leverage merchant confirms the difficulty facing leverage customers desiring to make a profit.106/ The authors of this study honestly state the problem:

> [Unlike a futures customer,] the leverage customer incurs further fees, a retail markup and the annual service fee, which means that a greater price increase is required for him to earn a profit.107/

IV. Reported Cases of Fraud and Abuse.

These potential public concerns about leverage have been confirmed both in cases finding violations of Commission antifraud regulations and in the rate of complaints by leverage customers. Since the Commodity Futures Trading Commission promulgated its general antifraud regulation for leverage transactions in 1975,108/ leverage merchants, advisors, account executives, and other sales personnel have been adjudicated guilty of numerous violations of the rule. These violations have included

- Misrepresenting the Transaction and the Merchant's Status: providing false or misleading literature or other information,109/
- Overreaching: using unconscionable agreements or pressure-sales tactics,110/
- Trading without Authorization: churning a customer's account or otherwise making unauthorized trades,111/
- Not Executing Customer Orders: failing to liquidate a customer's account upon his order,112/ or under conditions specified by the customer,113/
- Liquidating Accounts Improperly: liquidating a customer's account without notice or otherwise improperly,114/
- Inadequately Disclosing Risk: misinforming or failing to inform a customer about the mechanics and significant risks of leverage transactions generally,115/ and particular aspects of the customer's own transactions,116/
- Misrepresenting the Facts and the Law: misrepresenting the status of a customer's account and the customer's ability to protect against margin calls,117/ and misrepresenting that federal regulations only permitted account liquidation through telegraphic orders,118/ and
- Breaking the Contract: failing to deliver gold coins upon payment in full.119/

In one of the most publicized examples of abuses, one leverage merchant was found to have committed numerous statutory and regulatory violations, which included violating FCM net capital requirements, filing inaccurate forms concerning its net capital, disseminating fraudulent promotional literature, and making material omissions on registration applications.120/

Complaints to the Commodity Futures Trading Commission by customers of the four major leverage firms accounted for an average of 10.8% of all complaints filed with the Commission from fiscal year 1980 through June 1984, a significant increase over the period from fiscal years 1976 through 1979 when complaints by customers of these firms accounted for only 1.5% of all complaints filed with the Commission.121/

V. The Need for Reform

Congress and the CFTC are now facing the fork in the leverage road. Congress could direct the CFTC to lift its existing moratoria on new leverage firms and commodities, thereby permitting a widescale over-the-counter futures market to evolve under the leverage label. Or, Congress could mandate that leverage contracts are futures contracts and must therefore be traded on futures exchanges under the Commodity Exchange Act. A review of the inherent deficiencies of the CFTC's well meaning leverage rules and the likely adverse consequences that would flow from removing the CFTC moratoria demonstrate that finally treating leverage contracts as futures contracts is, by far, the better congressional course.

The Commission and Congress itself have at various times expressed concern about the Commission's ability to oversee expanded leverage trading.122/ Now that leverage regulations are in place, however, several commentators have asked the Commission to withdraw its admittedly anticompetitive moratoria on new entrants into the leverage area.123/

Serious doubts about the wisdom of having the Commission be responsible for a burgeoning leverage industry persist, since this direct regulation would be contrary to the Commission's established mandate to oversee exchange trading. Moreover, legitimizing certain off-exchange futures trading denominated as leverage will encourage outright boiler room operators to deal in leverage under a CEA scheme that may well hamper state regulators' pursuit of such operators. Finally, leverage contracts are subject to fewer CFTC prerequisites than futures contracts, an illogical and potentially anticompetitive result.

A. Interim Congressional and CFTC Responses Will Not Cure the Leverage Problem.

In 1982, Congress was alarmed by the absence of government regulation of leverage. CFTC reparation files documented widespread dishonorable and abusive leverage sales practices. Nevertheless, the CFTC had not promulgated comprehensive leverage rules due to its concern that such rules would legitimize instruments that had no commercial value and were the source of never ending customer complaints. Compounding congressional concern, the states were precluded from applying their regulatory schemes to leverage because leverage was covered under the umbrella of CFTC exclusive jurisdiction in section 2(a)(1) of the Commodity Exchange Act.124/

To address the leverage problem, Congress adopted a two-step approach.125/ First, the CFTC was directed to adopt regulations governing the existing leverage firms (those not subject to the CFTC moratoria).126/ Second, the CFTC was empowered to consider expanding the scope of permissible leverage business to the extent that such transactions would not be "contrary to the public interest."127/ The breadth of the second component of the CFTC's mandate belies any suggestion that Congress favored expanding leverage activity. To the contrary, Congress' decision to maintain the statutory prohibition on agricultural leverage,128/ at the same time Congress was lifting the prohibition on agricultural options,129/ clearly evidences Congressional distrust of leverage contracts.

Moreover, in 1982 Congress refused to approve or rescind the CFTC's leverage moratoria. Instead, Congress left to the agency's discretion whether its resources would be sufficient to ensure adequate public protection if the moratoria were made less restrictive.130/

Although expressing concern about the lack of economic purpose in leverage contracts,131/ the Commission in 1984 and early 1985 promulgated a series of regulations designed to curb some of the most blatant abuses in this area.132/ The regulations do not apply, however, to leverage transactions that do not meet the CFTC's definition of a leverage contract, in particular the requirement of a ten-year contract term.133/ The regulations now encompass both long and short leverage contracts,134/ illustrating even more starkly the similarities between futures and leverage contracts.

The CFTC rules, albeit extensive and well-intentioned, do not remedy any of the inherent deficiencies of off-exchange futures trading. The regulations also do not, because they cannot, resolve the underlying conflict of interest in leverage transactions, and make no attempt to require an economic purpose for these transactions.

Moreover, Congress' mandate and the Commission's ostensible authority to prevent manipulation in leverage contracts135/ is unattainable, as long as the leverage merchants themselves establish leverage commodity prices, resulting in inherently artificial prices rather than open and competitive market prices. For this reason, apparently, the CFTC has not adopted a regulation proscribing leverage manipulation. In addition, the CFTC has not imposed speculative position limits on leverage, which magnifies the risk, under the Commission's general speculative-limit theory, that leverage could be used to manipulate commodity prices not only in the leverage "markets" but also in the underlying cash and futures markets.

No clearinghouse or daily price limits protect leverage traders or the financial integrity of the leverage "markets." No statutory or regulatory provision even forbids leverage contracts based on individual securities; in contrast, Congress has explicitly prohibited futures contracts based on individual securities.136/

The Commission is in an intractable dilemma. Congress has permitted the CFTC to prohibit non-grandfathered leverage transactions it finds are "contrary to the public interest."137/ On the other hand, Congress has signalled the Commission to attempt to regulate other leverage transactions.138/ Given leverage merchants' express admission that their contracts have no economic purpose or "public interest" in the sense the Commodity Exchange Act contemplates139/ (a pronouncement with which the Commission apparently agrees140/), and given the inherent risks and inequities of leverage trading, the Commission has found itself fashioning an inescapably flawed regulatory scheme for the existing leverage industry.

Further evidence of the difficulty is Congress' express announcement that its 1982 amendments to the leverage provision did not limit the Commission's authority to "take appropriate action . . . against transactions masquerading as 'leverage' contracts."141/ Congress' direction to the CFTC on the one hand to suppress "unlawful" off-exchange futures and leverage trading appears inconsistent with its perceived direction to legitimize some off-exchange futures trading under the rubric of "leverage," since leverage contracts are futures contracts that should be unlawful under the CEA's seminal requirement of exchange trading.

Until Congress resolves whether leverage contracts are futures contracts, the CFTC may be forced to perpetuate solely speculative, and otherwise unlawful, over-the-counter futures trading with a built-in conflict of interest and a history of fraudulent sales practices.

B. Direct Regulation Foreign to Commission's Oversight Expertise.

Congress explicitly recognized in 1982 that CFTC expertise and resources were inadequate to control a variety of off-exchange commodities activities.142/ Congress thus declared "open season" on off-exchange futures transactions, giving the states and federal regulators concurrent jurisdiction to pursue those purveying futures contracts outside of the exchange setting in violation of federal law.143/ This development simply confirmed Congress' view that the CFTC's traditional mandate and expertise overwhelmingly favors CFTC oversight of self-regulated exchanges and not direct regulation of off-exchange transactions.

C. State Law Enforcement Difficulties.

Despite this 1982 reform, the statutory ambiguity over off-exchange futures contracts sold as leverage may unduly complicate state law enforcement efforts to combat boiler room operators. In one reported instance, a State of Texas enforcement action was procedurally delayed until the state could prove its jurisdiction by establishing that the off-exchange instrument at issue was not properly labeled a leverage contract.144/ Abolishing separate treatment for the leverage variety of futures contracts would make clear Congress' intention that the states have authority over all off-exchange futures transactions, thereby facilitating state law enforcement actions.

D. Leverage--The Next Source of Commodity Boiler Rooms.

There is strong evidence that leverage contracts will become the next great off-exchange scam of the apparently inexhaustible supply of "boiler room" operators. Indeed, boiler room leverage merchants already have appeared.

This is not surprising, since a boiler room operator who decides to offer to public customers an off-exchange futures contract needs only to set the price for each contract, become a party to these contracts, add other contract provisions unfavorable to the customer, institute a nominal contract period of either more or less than ten years (depending on which regulator seems less of a threat), and hang the respectable-sounding label "leverage" on his futures contract.

Even though leverage transactions are relatively recent phenomena, and CFTC-sanctioned leverage trading has been limited under existing moratoria, merchants that do not qualify under the moratoria to retail leverage to the public have found the rewards sufficiently lucrative to do so anyway. In 1984 alone at least three unauthorized leverage operations were uncovered.145/

E. Dangers to Legitimate Futures Industry.

Continued off-exchange leverage trading threatens the reputation of exchange-based futures trading and anomalously subjects exchange-traded futures contracts to higher regulatory costs and standards than leverage contracts.

Historically, any major scandal involving a commodity-type instrument has related to the retailing of off-exchange instruments.146/ Media and public perceptions, however, fail to distinguish unscrupulous purveyors of off-exchange instruments from the legitimate futures industry. As a result, off-exchange scandals have historically scarred public confidence in the integrity of commodity futures markets, resulting in calls for increased, more onerous government regulation of the legitimate industry. The leverage issue thus presents a serious threat to the futures industry's ability to continue to serve as a strong and important element of our nation's economy.

Off-exchange trading of leverage instruments, which are in fact futures contracts, also puts exchange-traded futures contracts at a competitive disadvantage because of the disparity in regulation of these similar instruments. Although leverage and futures contracts are basically indistinguishable (except that futures are exchange-traded as required by law), futures exchanges must run a much more rigorous regulatory gauntlet in order to attain and maintain designation as a contract market.

These additional regulatory protections are designed to promote market integrity and public confidence, but also make the initial and continuing cost of offering futures contracts greater than the cost to leverage merchants of offering the leverage variety of futures contracts. For example, a board of trade must provide detailed justification of delivery points and facilities, provide for the prevention of price manipulation and dissemination of false market information, and demonstrate an economic purpose for a contract before it can be designated as a market for a commodity futures contract.147/ Contract markets must also receive CFTC approval for and must enforce exchange rules, and must provide for open and competitive execution of trades.148/ Exchange clearinghouses and the clearing process also guarantee the financial integrity of each futures contract. These requirements, none of which are imposed on leverage merchants, increase the relative cost of offering exchange-traded futures contracts. It is an indefensible paradox that the present scheme subjects leverage contracts to fewer regulatory standards than legitimate futures contracts.

VI. Recommendation and Conclusion.

Congress has never examined fully the legal and public policy issues raised by leverage transactions. Any objective study would lead to the conclusion that the essential economic nature of leverage contracts is indistinguishable from that of traditional futures contracts. If leverage transactions are futures contracts, they should be regulated as such under the Commodity Exchange Act's traditional scheme.

Congress should therefore enact legislation to curb what undoubtedly will otherwise become widespread over-the-counter, non-exchange futures trading in the United States. To remove any possible doubt, this legislation should make explicit that leverage contracts are futures contracts that must be traded on exchanges subject to all other CEA and CFTC requirements for futures trading. The CFTC could oversee this exchange trading, and states would then be free to pursue purveyors of all off-exchange futures contracts.

Until this regulatory gap is closed, not only will an inherent potential for customer fraud continue as leverage merchants operate as principals to every contract as well as establish prices for the contracts, Congress and the Commission will be legitimizing off-exchange futures transactions that lack any commercial purpose.

Moreover, Congress will be emasculating the CEA's regulatory scheme by authorizing futures trading in the absence of the competitive and self-regulatory forces of an exchange. Such a result would represent a radical departure from a sixty-year congressional mandate that would be ill-advised for the CFTC, the futures industry, and more importantly, the public that benefits from futures trading. Indeed, unless properly remedied, members of the public will inevitably be harmed by the apparently insatiable band of bucket shop operators that prey upon weak, unsophisticated, and often financially desperate citizens and will look to leverage as the next great scam.

To be sure, this legislation would require leverage firms to restructure their business. The firms that offer leverage transactions are not without alternatives, however. Under the CEA, these firms could deal in cash sales and futures contracts, or become exchanges themselves. These firms already make cash commodity sales and purchases, and often have affiliates registered to deal in futures contracts.

The consistent claim of the leverage firms has been that any regulation would put them "out of business"; this cry was heard in 1974 when the states wanted to regulate leverage as securities,149/ in 1978 when the CFTC considered regulating leverage as futures,150/ and from 1983 to 1985 as the CFTC imposed various regulations on off-exchange leverage.151/ This argument obscures the fundamental issue.

Leverage today constitutes an unwarranted and unintended exception to the longstanding congressional judgment that the public interest in futures trading will be served only if futures contracts are traded on exchanges. The public interest, not that of the leverage firms, must be paramount. Thus, legislation to specify that leverage contracts are and must be regulated as futures contracts is needed.

APPENDIX: LEGISLATIVE HISTORY OF LEVERAGE REGULATION

The first federal regulation specifically addressing leverage contracts appeared in the Commodity Futures Trading Commission Act of 1974.152/ Section 217 of the 1974 Act prohibited entry into leverage transactions involving silver and gold bullion or bulk coins contrary to any Commission rule "designed to insure the financial solvency of the transaction or prevent manipulation or fraud," but added, "[i]f the Commission determines that any such transaction is a contract for future delivery within the meaning of the Commodity Exchange Act, as amended, such transaction shall be regulated in accordance with the provisions of that Act."153/ The committee report states that this amendment, added by the Senate, "requires" the Commission to regulate these transactions; and that if the Commission finds that such transactions are futures contracts, all of the requirements of the Act would be applicable to trading in such transactions.154/

As Congress considered reauthorization of the Commodity Futures Trading Commission in 1978, the Commission proposed that Congress repeal section 217, recommended that Congress give jurisdiction to securities regulators over leverage contracts that were not futures contracts, and announced that there was evidence to indicate that certain classes of leverage contracts were futures contracts which should be regulated as such.155/ After some dispute about what the Commission's position really was,156/ Congress repealed section 217 of the 1974 Act and enacted a new section 19 of the Commodity Exchange Act,157/ which in the words of the conference committee:

1. prohibits leverage transactions involving agricultural commodities enumerated in section 2(a) of the Commodity Exchange Act prior to 1974;
2. requires the Commission to regulate leverage transactions (as defined in the Senate bill) involving gold or silver bullion or bulk coins;
3. authorizes the Commission to prohibit or regulate leverage transactions involving all other commodities by October 1, 1979; and
4. authorizes the Commission to regulate any leverage transaction as a futures contract if it determines the transaction to be a contract for future delivery under the Commodity Exchange Act.158/

The Conference Committee restated its intent that the Commission act "expeditiously" under section 19 to regulate leverage contracts in gold and silver, and stated that "the Commission's authority to determine that any gold or silver leverage contract is a contract for future delivery and to treat that transaction as such is not to be casually exercised as a substitute for the regulation of that leverage contract."159/

Shortly before Congress enacted section 19, the Office of General Counsel of the Commission released a memorandum expressing the view that leverage contracts were futures contracts as the Commodity Exchange Act uses the term.160/ The conference committee made reference to this report in a footnote:

> The conferees did not contemplate, based on prior representations by the Commission, that the Commission would classify all gold and silver leverage contracts as contracts for future delivery. Therefore, the conferees expect that the Commission will not take final action on the recommendation contained in the memorandum until the Committee on Agriculture, Nutrition, and Forestry of the Senate and the House Committee on Agriculture have an opportunity to receive testimony on this issue.161/

The Commission's position that leverage transactions were futures contracts was one that evolved over time. The Commission appointed an advisory committee to study various types of commodity contracts in August 1975, and received the committee's report in July 1976.162/ The committee pointed out the differences between futures and leverage contracts and concluded that these contracts were not equivalent, emphasizing its apparent view that section 217 was an expression of congressional intent that the statutorily specified leverage contracts should be permitted unless they were incapable of regulation on a basis "designed to prevent fraud or manipulation or to insure financial solvency of the transactions."163/ On October 12, 1976, the Commission directed the staff to prepare guidelines for interim regulations.164/ More than a year later, on November 8, 1977, the CFTC again considered leverage transactions and appointed a task force to study them further.165/

The Commission's Division of Enforcement prepared a Survey of Leverage Trading in April 1978,166/ and based on that survey the Office of Chief Economist issued a report in May 1978 concluding that leverage contracts were essentially futures contracts.167/ The memorandum of the Office of General Counsel followed.168/ After being reauthorized, and after imposing a moratorium on new entrants into the leverage field,169/ the Commission on March 12, 1979, requested comment on whether it should adopt the 1978 memorandum of the Office of General Counsel and regulate leverage contracts as futures contracts, or whether it should promulgate a comprehensive regulatory scheme for leverage contracts.170/ The Commission received comments, and announced on July 27, 1979, that leverage contracts of the type being offered to the public were in fact futures contracts.171/ Pursuant to the direction in the conference report, the Commission informed Congress of its intentions and that "[i]n the absence of a statutory change, the Commission expects to take final action on its determination sometime before the proposed effective date of January 1, 1980."172/

The chairmen and ranking minority members of the Senate Agriculture Committee and the House Agriculture Committee and Subcommittee on Conservation and Credit wrote letters to the Chairman of the Commission on November 15 and 16, 1979, suggesting that the effective date of the July 1979 proposal to regulate leverage as futures be postponed and that the Commission establish a regulatory solution.173/ The Commission effectively postponed the issue until its 1982 reauthorization.174/

During the 1982 reauthorization process, the Commission sought codification of its moratoria pending additional study of the leverage issue;175/ Congress did not expressly adopt this proposal.176/ The House wanted not only to repeal section 19(d), which it believed permitted the Commission to ban leverage transactions that it found were futures contracts, it also wanted to repeal the Commission's discretionary authority to prohibit certain leverage transactions under the financial solvency, manipulation, and fraud provisions of section 19(b).177/ The Senate did not believe repeal of section 19(d) was necessary, but expressed its view that the section was "intended solely to enable the Commission to protect the public from attempts to disguise off-exchange trading in futures contracts as the purchase of commodities through otherwise lawful leverage transactions."178/ The conference committee steered a path between the two proposals. Pursuant to its compromise, Congress repealed section 19(d), but amended section 19(c) to include language permitting the Commission to prohibit any leverage transaction which was not permitted by the rules, regulations, and orders of the Commission in effect on December 9, 1982, if the Commission determines that such transaction would be "contrary to the public interest."179/ The committee reports unanimously expressed concern over the anticompetitive nature of the regulatory moratoria on leverage firms and contracts, but permitted continuance of the moratoria until regulations dealing with leverage transactions were in place and the Commission was able to regulate an expanded leverage industry.180/ Moreover, colloquy on the floor of the Senate makes clear that committee consideration of leverage legislation in 1982 "did not focus on the issue of what constitutes a leverage contract".181/

Congressional interest in leverage revived in 1984. A provision dealing with leverage contracts appeared in H.R. 5743, the appropriations bill for Agriculture, Rural Development, and Related Agencies programs. This provision, section 627, had been offered as an amendment by Senator Richard Lugar and had been adopted in the Senate version of the bill. The provision would have prohibited the Commodity Futures Trading Commission from lifting its present moratoria on the entry of new firms into the leverage business until sixty days after the Commission transmitted to Congress documentation of its ability to regulate such transactions successfully.182/ In requesting that the provision be deleted in conference, Congressman E (Kika) de la Garza, Chairman of the House Agriculture Committee, offered to ask the Subcommittee on Conservation, Credit, and Rural Development to hold a hearing in 1985 on the leverage issue. In the words of Chairman de la Garza, "these issues need to be aired fully in a public hearing."183/ The amendment was deleted in conference.

FOOTNOTES

1/ The Commodity Futures Trading Commission is also referred to herein as the Commission or the CFTC.

2/ The Commission imposed moratoria on new merchants of gold and silver leverage contracts in late 1978, *see* 17 C.F.R. § 31.1 (1984), and on leverage contracts of any merchant in other commodities which were not being offered as of February 2, 1979, *see* 17 C.F.R. § 31.2 (1984).

3/ 17 C.F.R. §§ 31.4-31.24 (1984), *as amended* by 50 Fed. Reg. 22 (1985). *See also* 50 Fed. Reg. 102 (1985) (proposed rules).

4/ *See* *Commodity Futures Trading Commission Act: Hearings Before the Senate Comm. on Agriculture and Forestry*, 93d Cong., 2d Sess. 748 (1974) (statement of M. Martin Rom, Chm., International Precious Metals Corp.) ("form of contract for future delivery") [hereinafter cited as *1974 Hearings*]. *See also id.* at 749, 751, 752.

5/ Commodity Futures Trading Commission Study Group, Report for the Commission: Trading in Leverage Contracts for Gold and Silver, Project No. 217, at 4-5 (Apr. 18, 1975).

6/ Comments of Merrill Lynch Futures Inc., on Proposed Regulations to Govern Leverage Contracts and Transactions, CFTC Docket No. 83-28, at 4 (Aug. 22, 1983) (summarizing public disclosures of leverage firms: $7 billion sales for Monex International, Ltd., (Monex) through 1982; $1 billion for International Precious Metals Corp. (IPMC) through 1982; First National Monetary Corp. (FNMC) boasted 13,000 customers in 1982).

7/ Commodity Futures Trading Commission, Summary of Division of Enforcement Survey of Leverage Trading, at 2 (Apr. 27, 1978) [hereinafter cited as Enforcement Div. Survey Summary].

8/ *See* S. Rep. No. 384, 97th Cong., 2d Sess. 51 (1982) (four existing firms). The Commission moratoria, *see* 17 C.F.R. §§ 31.1, 31.2 (1984), apparently limited the leverage "industry" to four merchants dealing primarily in precious metals and bulk coin contracts--Monex, FNMC, IPMC, and Premex, Inc. *See* Letter from Susan M. Phillips, Chairman, CFTC, to Hon. Richard L. Lugar, Enclosure A (July 23, 1984). Premex is now in receivership. *See infra* note 120. A fifth firm, American Coin Exchange, also claims to be "grandfathered" under the CFTC rules.

9/ The history of leverage regulation is summarized in the Appendix.

10/ 7 U.S.C. § 23(a) (1982).

11/ Section 217 of the Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389, 1405, used "definitional" language virtually identical to that in present section 19(a) of the Commodity Exchange Act.

12/ P. Johnson, Commodities Regulation § 1.08, at 25 (1982).

13/ See, e.g., Comments of IPMC on Proposed Rules for the Regulation of Certain Leverage Transactions, CFTC Docket No. 83-28, at 2(14) (Aug. 22, 1983) [hereinafter cited as Rulemaking Comments of IPMC]; Comments of FNMC on Regulations for Certain Leverage Transactions, CFTC Docket No. 83-28, at 18 (Aug. 22, 1983) [hereinafter cited as Rulemaking Comments of FNMC]; Greenstone, Leverage Transactions: On Creating A Regulatory Theme, 27 Emory L.J. 909, 913 (1978).

14/ See CFTC Reauthorization: Hearings Before the Subcomm. on Conservation, Credit, and Rural Development of the House Comm. on Agriculture, 97th Cong., 2d Sess. 483-84 (1982) (statement of Louis Carabini, President, Monex) [hereinafter cited as Conservation Subcomm. Hearings].

15/ See, e.g., Rulemaking Comments of FNMC, supra note 13, at 18; Rulemaking Comments of IPMC, supra note 13, at 2(12- 13); Comments of Monex on Proposed Provisions for Certain Leverage Transactions, CFTC Docket No. 83-28, at 5-6 (Aug. 19, 1983) [hereinafter cited as Rulemaking Comments of Monex].

16/ Conservation Subcomm. Hearings, supra note 14, at 483-84 (statement of Louis Carabini, President, Monex); see also H.R. Rep. No. 565, 97th Cong., 2d Sess., pt. 1, at 110-11 (1982) (letter from Philip McB. Johnson, Chairman, CFTC, citing Report of the Advisory Committee on Market Instruments to the Commodity Futures Trading Commission, [1975-77] Comm. Fut. L. Rep. (CCH) ¶ 20,192, at 21,089 (1978)); S. Rep. No. 850, 95th Cong., 2d Sess. 26 (1978); P. Johnson, supra note 12, § 1.08, at 23-24; Greenstone, supra note 13, at 913-15.

17/ See 17 C.F.R. § 31.4(w) (1984), as amended by 50 Fed. Reg. 22, 27 (1985):

> "Leverage contract" means a contract, standardized as to terms and conditions, for the long-term (ten years or longer) purchase ("long leverage contract") or sale ("short leverage contract") by a leverage customer of a leverage commodity which provides for:
>
> (1) Participation by the leverage transaction merchant as a principal in each leverage transaction;
>
> (2) Initial and maintenance margin payments by the leverage customer;

(3) Periodic payment by the leverage customer or accrual by the leverage transaction merchant of a variable carrying charge or fee on the unpaid balance of a long leverage contract, and periodic payment or crediting by the leverage transaction merchant to the leverage customer of a variable carrying charge or fee on the initial value of the contract plus any margin deposits made by the leverage customer in connection with a short leverage contract;

(4) Delivery of a commodity in an amount and form which can be readily purchased and sold in normal commercial or retail channels;

(5) Delivery of the leverage commodity after satisfaction of the balance due on the contract; and

(6) Determination of the contract purchase and repurchase, or sale and resale prices by the leverage transaction merchant.

18/ Rulemaking Comments of FNMC, supra note 13, at 17-18; Rulemaking Comments of Monex, supra note 15, at 6.

19/ See, e.g., Offering Statement of Monex at 3 (Feb. 1, 1983).

20/ Offering and Disclosure Statement at 9 (May 21, 1984), Leverage Commodity Registration Application of Monex for 1000 Troy Ounces of .999 Fine Silver Bullion, App. F. (June 29, 1984) [hereinafter cited as Monex Silver Registration Application]. This merchant's disclosure statement for its bulk coins contract is identical to that for its silver contract. See Offering and Disclosure Statement, Leverage Commodity Registration -- South African Krugerrand, South African Half Rand, South African Tenth Rand, South African Two Rand, Austrian 100 Corona, Mexican 50 Peso, and Canadian $50 Maple Leaf Gold Coins, App. E (Aug. 31, 1984).

21/ Offering and Disclosure Statement at 6, Monex Silver Registration Application, supra note 20; see also FNMC Customer Suitability and Account Agreement at 2 (Nov. 1984) [hereinafter cited as FNMC Contract]; IPMC Risk Disclosure Statement and Leverage Account Agreement at 6 (May 24, 1984) (no guarantee to repurchase leverage contract sold to customer) [hereinafter cited as IPMC Contract].

22/ Commodity Futures Trading Commission Reauthorization: Hearings Before the Subcomm. on Agricultural Research and Gen. Legislation of the Senate Comm. on Agriculture, Nutrition, and Forestry, 97th Cong., 2d Sess. 278 (1982) (remarks of Louis Carabini, President, Monex) ("[I]t is not used as a price discovery mechanism nor risk shifting. Our customers assume the risk.") [hereinafter cited as Senate Subcomm. Hearings]; Conservation Subcomm. Hearings, supra note 14, at 428 (statement of Louis Carabini, President, Monex); *id.* at 440 (remarks of Mr. Carabini); Rulemaking Comments of IPMC, *supra* note 13, at 2(15) & n.8.

23/ Rulemaking Comments of FNMC, *supra* note 13, at 8-9, 33-34; *see* *Conservation Subcomm. Hearings*, *supra* note 14, at 492 (statement of Louis Carabini, President, Monex) (used to protect against inflation); Rulemaking Comments of IPMC, *supra* note 13, at 2(15) n.8 (leverage transactions are not a type of commodity imbued with a public interest); *id.* at 2(55) (no commercial justification required).

24/ *See* Offering and Disclosure Statement at 6, Monex Silver Registration Application, *supra* note 20 ("[P]recious metals and currencies involve risk as well as opportunity. Historically, there have been periods of varying length, long and short, during which the prices of commodities have moved downward. . . . Gold and currencies are particularly subject to government action for economic or political reasons. It is impossible to forecast accurately how or to what degree these or other factors will affect prices."); Transcript at 59, Meeting of Commodity Futures Trading Commission (June 12, 1984) (comments of Dr. Paula Tosini, Div. of Economic Analysis) ("If you're asking do I think there's a strong argument that previous metals -- there's a defensible argument that precious metals are a hedge against inflation. . . . I think it is an area that most or many professional economist[s] would not agree to.").

25/ *See* 17 C.F.R. § 31.2 (1984) (limiting commodities through moratorium); *Conservation Subcomm. Hearings*, *supra* note 14, at 482 (statement of Louis Carabini, President, Monex); *id.* at 497 (statement of James Groberg, Chm., IPMC); Enforcement Div. Survey Summary, *supra* note 7, at 1; Rulemaking Comments of IPMC, *supra* note 13, at 2(4).

26/ *See* 17 C.F.R. § 31.4(w) (1984).

27/ *See generally* Rulemaking Comments of FNMC, *supra* note 13, at 9; Rulemaking Comments of IPMC, *supra* note 13, at 2(4).

28/ *See* Regulation of Certain Leverage Transactions, 49 Fed. Reg. 5498, 5499-500 (1984).

29/ *See* Comments of FNMC on Regulation of Certain Leverage Transactions, CFTC Docket No. 84-12 (Mar. 27, 1984); Comments of IPMC on Proposed Amendments to Interim Final Rules, CFTC Docket No. 84-12 (Mar 27, 1984); Comments of Monex on the Regulation of Certain Leverage Transactions, CFTC Docket No. 84-12 (March 27, 1984).

30/ *See* 50 Fed. Reg. 22 (1985).

31/ Rulemaking Comments of FNMC, supra note 13, at 9.

32/ See, e.g., Leschuk v. First National Monetary Corp., 2 Comm. Fut. L. Rep. (CCH) ¶ 22,475, at 30,107 (CFTC Jan. 23, 1985) (initial decision) (impression of exchange trades); Weinberger v. First National Monetary Corp., 2 Comm. Fut. L. Rep. (CCH) ¶ 22,458 at 30,023 (CFTC Dec. 7, 1984) (initial decision) (thrust of brochures and oral representations were that buying and selling were conducted on some form of open or public market or exchange).

33/ See Offering and Disclosure Statement at 5, Monex Silver Registration Application, supra note 20 ("Monex bid and ask prices are not tied to prices quoted by any other organization"); IPMC Contract, supra note 21, at 5; FNMC Contract, supra note 21, at 3.

34/ See Rulemaking Comments of IPMC, supra note 13, at 2(15).

35/ See 17 C.F.R. § 31.4(w)(6) (1984), as amended by 50 Fed. Reg. 22, 27 (1985).

36/ See Weinberger v. First National Monetary Corp., 2 Comm. Fut. L. Rep. (CCH) ¶ 22,458, at 30,023-24 (CFTC Dec. 7, 1984) (initial decision).

37/ See IPMC Contract, supra note 21, at 5 (20%, subject to change); Offering and Disclosure Statement at 5, Monex Silver Registration Application, supra note 20 (example using 25% margin).

38/ E.g., Offering and Disclosure Statement at 4, Monex Silver Registration Application, supra note 20 (up to 2%); IPMC Contract, supra note 21, at 4 ("sales charge").

39/ Conservation Subcomm. Hearings, supra note 14, at 424 (statement of David Simon, Director and Gen. Counsel, FNMC); id. at 426 (statement of Louis Carabini, President, Monex); IPMC Contract, supra note 21, at 4.

40/ E.g., Offering and Disclosure Statement at 4, Monex Silver Registration Application, supra note 20 (2% fee).

41/ E.g., id. (up to 2%); IPMC Contract, supra note 21, at 4-5 ("termination charge").

42/ E.g., Monex Silver Registration Application, supra note 20, at 28 (assaying done at merchant's option and customer's expense when customer makes delivery); Rulemaking Comments of IPMC, supra note 13, Exh. 2, at 1 ("certification fee"); FNMC Contract, supra note 21, at 2 (same).

43/ Monex Silver Registration Application, supra note 20, at 2 ($.25 per troy oz. premium if customer takes delivery of 1000 oz.

silver contract in 100 troy oz. bars); id. at 3 ($50 handling fee if customer takes delivery of 1000 troy oz. bar).

44/ E.g., id. at 3 (customer pays delivery charges to and from merchant's office); IPMC Contract, supra note 21, at 5.

45/ E.g. IPMC Contract, supra note 21, at 5; Risk and Disclosure Statement at 5, Monex Silver Registration Application, supra note 20; FNMC Contract, supra note 21, at 2, 3.

46/ See, e.g., Risk and Disclosure Statement at 5, 9, Monex Silver Registration Application, supra note 20.

47/ Rulemaking Comments of FNMC, supra note 13, at 12; Rulemaking Comments of Monex, supra note 15, at 6. Merchants have provided a market for customers to offset transactions even though not specifically required to do so under some past contracts. See Rulemaking Comments of IPMC, supra note 13, at 2(7).

48/ Enforcement Div. Survey Summary, supra note 7, at 2 (90% closed out by offsetting transactions); Report of the Advisory Committee on Market Instruments to the Commodity Futures Trading Commission, [1975-77] Comm. Fut. L. Rep. (CCH) ¶ 20,192, at 21,089-90 (July 16, 1976); Greenstone, supra note 13, at 914-15.

49/ See Rulemaking Comments of IPMC, supra note 13, Exh. 9, at 7 n.6 (11.5 month average account life); Enforcement Div. Survey Summary, supra note 7, at 2; Comments of Silver Users Association on Proposed Regulations for Certain Leverage Transactions, CFTC Docket No. 83-28, at 2 (Aug. 19, 1983); Comments of First Commodity Corp. of Boston on Proposed Rules Governing the Offer and Sale of Leverage Transactions, CFTC Docket No. 83-28, at 2 (July 1, 1983) ("within one year").

50/ See Rulemaking Comments of IPMC, supra note 13, at 2(5) (contracted to "cover" although not required to do so by law); cf. 17 C.F.R. § 31.8 (1984), as amended by 50 Fed. Reg. 22, 28-29 (1985).

51/ See Rulemaking Comments of IPMC, supra note 13, at 2(5); Rulemaking Comments of FNMC, supra note 13, at 17.

52/ See S. Rep. No. 850, supra note 16, at 26; Enforcement Div. Survey Summary, supra note 7, at 2; Offering and Disclosure Statement at 9, Monex Silver Registration Application, supra note 20; see also 17 C.F.R. § 31.8(a)(2) (1984) (loans up to 90% of warehouse-receipts value permitted).

53/ Rulemaking Comments of Monex, supra note 15, at 20 (using example of gold bullion obligations covered by gold coin positions); *see also* 17 C.F.R. § 31.8(a)(2) (1984), *as amended by* 50 Fed. Reg. 22, 28-29 (1985) (same generic commodity).

54/ *In re* Premex, Inc., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,877, at 27,733 (CFTC July 12, 1982) (initial decision), *aff'd*, [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,992 (CFTC Feb. 1, 1984).

55/ *1974 Hearings*, *supra* note 4, at 748 (statement of M. Martin Rom, Chm., IPMC).

56/ *See*, *e.g.*, section 2(a)(1) of the Commodity Exchange Act, 7 U.S.C. § 2 (1982); section 2(a)(8)(B), 7 U.S.C. § 4a(g)(2) (1982); section 4a(1), 7 U.S.C. § 6a(1) (1982); section 4b, 7 U.S.C. § 6b (1982); section 4d, 7 U.S.C. § 6d (1982); section 4e, 7 U.S.C. § 6e (1982); section 5(a), 7 U.S.C. § 7(a) (1982). *But cf.* section 4(a), 7 U.S.C. § 6(a) (1982) ("purchase or sale of a commodity for future delivery"); section 4d, 7 U.S.C. § 6d (1982) (same).

57/ *See*, *e.g.*, Merrill Lynch, Pierce, Fenner & Smith v. Curran, 456 U.S. 353, 358-59 (1982); Precious Metals Associates, Inc. v. CFTC, 620 F.2d 900, 905 (1st Cir. 1980); Cargill, Inc. v. Hardin, 452 F.2d 1154, 1156 n.2, 1157-58 (8th Cir. 1971); Breyer v. First National Monetary Corp., 548 F. Supp. 955, 963 (D.N.J. 1982); CFTC v. National Coal Exchange, Inc., [1980-82] Comm. Fut. L. Rep. (CCH) ¶ 21,424, at 26,053-55 (W.D. Tenn. Apr. 2, 1982); CFTC v. Comercial Petrolera International, S.A., [1980-82] Comm. Fut. L. Rep. (CCH) ¶ 21,222 (S.D.N.Y. June 26, 1981); CFTC v. Co Petro Marketing Group, Inc., 502 F. Supp. 806 (C.D. Cal. 1980), *aff'd*, 680 F.2d 573 (9th Cir. 1982); *In re* First National Monetary Corp., [1982-84] Comm. Fut. L. Rep. ¶ 21,707, at 26,773-74 (CFTC Apr. 29, 1983) (initial decision); *In re* Stovall, [1977-80] Comm. Fut. L. Rep. (CCH) ¶ 20,941 (CFTC Dec. 6, 1979).

58/ *See In re* Stovall, [1977-80] Comm. Fut. L. Rep. (CCH) ¶ 20,941, at 23,779 (CFTC Dec. 6, 1979).

59/ 680 F.2d 573 (9th Cir. 1982).

60/ *See id.* at 579-81.

61/ *Id.* at 581.

62/ [1980-82] Comm. Fut. L. Rep. (CCH) ¶ 21,424 (W.D. Tenn. Apr. 2, 1982).

63/ *See id.* at 26,055.

64/ *See id.* at 26,053.

65/ *In re* First National Monetary Corp. and Monex Int'l, Ltd., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,707 (CFTC Apr. 29, 1983) (initial decision). This holding has been followed in Leschuk v. First National Monetary Corp., 2 Comm. Fut. L. Rep. (CCH) ¶ 22,475, at 30,108 (CFTC Jan. 23, 1985) (initial decision); Golden v. First National Monetary Corp., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,749 at 27,014-15 (CFTC May 19, 1983) (initial decision).

66/ *In re* First National Monetary Corp. and Monex Int'l, Ltd., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,707, at 26,775 (CFTC Apr. 29, 1983) (initial decision).

67/ *See id.* at 26,781.

68/ *See id.* at 26,778-79.

69/ *See* Offering and Disclosure Statement at 8, Monex Silver Registration Application, *supra* note 20.

70/ *See* 17 C.F.R. § 31.4(w) (1984).

71/ *See* CFTC v. Co Petro Marketing Group, Inc., 680 F.2d 573, 580 (9th Cir. 1982); CFTC v. National Coal Exch., Inc., [1980-82] Comm. Fut. L. Rep. (CCH) ¶ 21,424, at 26,055 (W.D. Tenn. Apr. 2, 1982).

72/ *See* *Conservation Subcomm. Hearings*, *supra* note 14, at 491 (statement of Louis Carabini, President, Monex); *id.* at 506 (statement of James Groberg, Chm., IPMC).

73/ *Cf.* Clark, *Genealogy and Genetics of "Contract of Sale of a Commodity for Future Delivery,"* 27 Emory L.J. 1175, 1175-78, 1179, 1191-92 (1978).

74/ Commodity Exchange Act § 2(a)(1)(A), 7 U.S.C. § 2 (1982).

75/ *See supra* notes 16, 48 and accompanying text.

76/ CFTC v. Co Petro Marketing Group, Inc., 680 F.2d 573, 577-79 (9th Cir. 1982); *In re* Stovall, [1977-80] Comm. Fut. L. Rep. (CCH) ¶ 20,941, at 23,778 (CFTC Dec. 6, 1979); *In re* First National Monetary Corp., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,707, at 26,779-80 (CFTC Apr. 29, 1983) (initial decision).

77/ *See* Rulemaking comments of IPMC, *supra* note 13, at 2(16); *see generally* Report of the Advisory Committee on Market Instruments to the Commodity Futures Trading Commission, [1975-77] Comm. Fut. L. Rep. (CCH) ¶ 20,191, at 21,089 (July 16, 1976); P. Johnson, *supra* note 12, § 1.08, at 23; *id.* § 1.17, at 58-59.

78/ *See supra* note 48 and accompanying text.

79/ *See* Office of General Counsel, Commodity Futures Trading Commission, Memorandum on Settlement Provision of the Proposed CME Eurodollar Contract (Dec. 2, 1981).

80/ *See* R. Gray & D. Rutledge, The Commodity Leverage Contract: An Economic Analysis 4 (1978), *in* Rulemaking Comments of IPMC, *supra* note 13, Exh. 9.

81/ *See* Rulemaking Comments of IPMC, *supra* note 13, at 2(16), 2(17).

82/ Rulemaking Comments of Monex, *supra* note 15, at 6.

83/ *In re* Stovall, [1977-80] Comm. Fut. L. Rep. (CCH) ¶ 20,941, at 23,779 (CFTC Dec. 6, 1979).

> To permit execution other than on a contract market would invite bucket shops and other fraudulent and nonregulated activities to the detriment of the public and in contravention of the history of commodity regulation, which was designed to insure honest dealings and protection of the public. . . .

Id. (citing initial decision).

84/ Ch. 86, § 4, 42 Stat. 187, 187.

85/ *See* Hill v. Wallace, 259 U.S. 44 (1922).

86/ Grain Futures Act of 1922, ch. 369, § 4, 42 Stat. 998, 999-1000.

87/ Commodity Exchange Act § 4(a), 7 U.S.C. § 6(a) (1982).

88/ *See* *In re* Stovall, [1977-80] Comm. Fut. L. Rep. (CCH) ¶ 20,941, at 23,779 (CFTC Dec. 6, 1979).

89/ *See* Commodity Exchange Act, ch. 545, § 4b(D), 49 Stat. 1491, 1493 (1936) (prohibition on bucketing).

90/ *See* 80 Cong. Rec. 8088 (1936) (remarks of Sen. Pope), cited in 44 Fed. Reg. 13,494, 13,500 n.30 (1979).

91/ 61 Cong. Rec. H1318 (May 11, 1921), *cited in* P. Johnson, *supra* note 12, § 2.03 at 211-12 n.6.

92/ *See generally* Commodity Exchange Act § 3, 4b, 7 U.S.C. § 5, 6b (1982) (benefit of futures trading); 17 C.F.R. § 1.38 (1984) (requiring competitive execution).

93/ *See* *In re* Stovall, [1977-80] Comm. Fut. L. Rep. (CCH) ¶ 20,941 at 23,779 (CFTC Dec. 6, 1979).

94/ *See*, *e.g.*, Commodity Exchange Act §§ 5(c), 5(d), 5(f), 5a(8), 7 U.S.C. §§ 7(c), 7(d), 7(f), 7a(8) (1982).

95/ *See* S. Rep. No. 850, *supra* note 16, at 22.

96/ Commodity Exchange Act § 5(g), 7 U.S.C. § 7(g) (1982).

97/ *See* H.R. Rep. No. 1383, 93d Cong., 2d Sess. 36 (1974); H.R. Rep. No. 975, 93d Cong., 2d Sess. 29 (1974); *see generally* T. Russo, Regulation of the Commodities, Futures and Options Markets, §§ 1.38-1.39 (1983) (history and mechanics of requirement).

98/ Transcript at 44, Meeting of Commodity Futures Trading Commission (June 12, 1984) (remarks of Commissioner William Seale).

99/ *See* Rulemaking Comments of IPMC, *supra* note 13, at 2(15) n.8; *supra* notes 22-23 and accompanying text.

100/ *See* Offering and Disclosure Statement at 10, Monex Silver Registration Application, *supra* note 20.

101/ *Id*. at 6, 10.

102/ *See*, *e.g.*, Weinberger v. First National Monetary Corp., 2 Comm. Fut. L. Rep. (CCH) ¶ 22,458, at 30,024 (CFTC Dec. 7, 1984) (initial decision) (allowing unprofitable leg of customer's straddle to continue while liquidating profitable leg shows firm's personal interest contrary to customer's).

103/ Letter from Susan M. Phillips, Chairman, CFTC, to Sen. Richard Lugar, Enclosure D at 2 (July 23, 1984).

104/ *See* *id*.

105/ *See* *id*. at 4.

106/ *See* R. Gray & D. Rutledge, *supra* note 80, at 8.

107/ *See* *id*.

108/ *See* 17 C.F.R. § 31.3 (1984) (current version); 40 Fed. Reg. 26,504 (1975). The Commission promulgated the regulation under its authority to issue rules, regulations, and orders "to insure the financial solvency of the transaction or prevent manipulation or fraud." Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, § 217(a), 88 Stat. 1389, 1405. The Commission's present rulemaking authority is codified in section 19 of the Commodity Exchange Act, 7 U.S.C. § 23 (1982).

109/ CFTC v. Premex, Inc., 655 F.2d 779 (7th Cir. 1981); Leschuk v. First National Monetary Corp., 2 Comm. Fut. L. Rep. (CCH) ¶ 22,475 (CFTC Jan. 23, 1985) (initial decision); Weinberger v. First National Monetary Corp., 2 Comm. Fut. L. Rep. (CCH) ¶ 22,458 (CFTC Dec. 7, 1984) (initial decision); Ferguson v. United Precious Metals, Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 22,431 (CFTC Nov. 27, 1984) (initial decision).

110/ Wagner v. International Precious Metals Corp., 2 Comm. Fut. L. Rep. (CCH) ¶ 22,344 (CFTC Sept. 7, 1984) (initial decision); Zavish v. International Precious Metals Corp., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,775 (CFTC July 19, 1983) (initial decision), review denied, [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 22,067 (CFTC Mar. 22, 1984).

111/ Piskur v. International Precious Metals Corp., [1982- 1984] Comm. Fut. L. Rep. (CCH) ¶ 21,664 (CFTC Nov. 4, 1982) (initial decision), review granted, No. R 80-1186-81-142 (CFTC Mar. 16, 1983); CFTC v. Trending Cycles for Commodities, Inc., No. 80-315-CIV-JWK, [1980-82] Comm. Fut. L. Rep. (CCH) ¶ 21,013 (S.D. Fla. Mar. 17, 1980) (order making fact findings and legal conclusions).

112/ Golden v. First National Monetary Corp., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,749 (CFTC May 19, 1983) (initial decision); Jackson v. Premex, Inc., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,618 (CFTC Nov. 17, 1982) (presiding officer); Walton v. First New York Investors Corp., [1977-80] Comm. Fut. L. Rep. (CCH) ¶ 20,961 (CFTC Jan. 21, 1980) (initial decision); Matthews v. Monex International, Ltd., [1977-80] Comm. Fut. L. Rep. (CCH) ¶ 20,791 (CFTC Mar. 16, 1979) (initial decision), review denied, [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,899 (CFTC Jan. 27, 1983).

113/ Todd v. First National Monetary Corp., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 22,029 (CFTC Feb. 29, 1984) (initial decision), remanded in part on other grounds, 2 Comm. Fut. L. Rep. (CCH) ¶ 22,333 (CFTC Aug. 27, 1984) (damages calculation).

114/ Russo v. International Precious Metals Corp., 2 Comm. Fut. L. Rep. (CCH) ¶ 22,453 (CFTC Dec. 18, 1984) (initial decision); Cook v. Monex International, Ltd., 2 Comm. Fut. L. Rep. (CCH) ¶ 22,208 (CFTC May 25, 1984) (initial decision); Breclaw v. International Precious Metals Corp., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,915 (CFTC Nov. 30, 1983) (initial decision), review denied, No. R 81-167-81-782 (CFTC Oct. 11, 1984); Moreira v. First National Monetary Corp., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,914 (CFTC Nov. 28, 1983) (initial decision), review denied, 2 Comm. Fut. L. Rep. (CCH) ¶ 22,430 (CFTC Nov. 28, 1984).

115/ Keller v. First National Monetary Corp., 2 Comm. Fut. L. Rep. (CCH) ¶ 22,402 (CFTC Oct. 22, 1984); Annunziata v. International

Precious Metals Corp., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 22,079 (CFTC Mar. 7, 1984) (initial decision); Moreira v. First National Monetary Corp., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,914 (CFTC Nov. 28, 1983) (initial decision), review denied, 2 Comm. Fut. L. Rep. (CCH) ¶ 22,430 (CFTC Nov. 28, 1984); Zavish v. International Precious Metals Corp., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,775 (CFTC July 19, 1983) (initial decision), review denied, [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 22,067 (CFTC Mar. 22, 1984); Mitchell v. Premex, Inc., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,678 (CFTC Feb. 10, 1983) (initial decision).

116/ Thielker v. Bonaire Trading Corp., [1980-82] Comm. Fut. L. Rep. (CCH) ¶ 21,404 (CFTC May 13, 1982) (initial decision) (initial payment went toward front-loaded fees and not toward commodity purchase).

117/ Campbell v. International Precious Metals Corp., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,816 (CFTC July 22, 1983) (initial decision).

118/ Walton v. First New York Investors Corp., [1977-80] Comm. Fut. L. Rep. (CCH) ¶ 20,961 (CFTC Jan. 21, 1980) (initial decision).

119/ Christiansen v. First National Monetary Corp., 2 Comm. Fut. L. Rep. (CCH) ¶ 22,436 (CFTC Nov. 14, 1984) (initial decision).

120/ In re Premex, Inc., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 21,992 (CFTC Feb. 1, 1984). This leverage merchant had registered as a futures commission merchant, which was not required for the merchant to engage in leverage transactions. See id. The Commission's sanctions included revocation of the merchant's FCM registration, a ban on contract-market trading except for the purpose of liquidating customer positions, and a prohibition on soliciting or accepting funds from the public. Id., aff'g In re Premex, Inc., [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 22,010 (CFTC Feb. 9, 1984). The firm ultimately was put into receivership. See CFTC v. Premex, Inc., No. 84-0375-E(M), [1982-84] Comm. Fut. L. Rep. (CCH) ¶ 22,061 (S.D. Cal. Mar. 15, 1984); see also CFTC v. Premex, Inc., No. 84-0375-E(M), [1982-84] Comm. Fut. L. Rep. ¶ 22,035 (S.D. Cal. Feb. 29, 1984) (injunction against Premex).

121/ The breakdown of public complaints about these leverage firms is as follows:

Fiscal Year	Complaints Filed Against Four Leverage Firms	Total Complaints Filed	% of Total
1976	2	63	3.2%
1977	3	540	.5%

1978	2	873	.2%
1979	29	903	3.2%
1980	170	1,401	12.1%
1981	161	1,415	11.4%
1982	97	1,079	9.0%
1983	95	916	10.4%
1984 (10/1-6/30)	41	432	9.5%

Letter from Susan M. Phillips, Chairman, CFTC, to Sen. Richard Lugar, Enclosure B (July 23, 1984). The analysis of these figures by leverage firm for the years 1982 to 1984 is as follows:

	FNMC	IPMC	Premex	Monex	Total
1982	38	16	25	18	97
1983	50	18	15	12	95
1984 (10/1-6/30)	20	1	13	7	41

Id.

These statistics cover only complaints from customers of Monex International, Ltd., International Precious Metals Corp., First National Monetary Corp., and Premex, Inc. No complaints against Premex, Inc., were accepted after April 23, 1984, because new reparations rules require dismissal of cases against firms such as Premex, Inc., which are in receivership. Complaints against persons not registered with the Commission were included in "total complaints filed" only until May 11, 1983. *Id.*

122/ *See, e.g.*, H.R. Rep. No. 964, 97th Cong., 2d Sess. 50-51 (1982); Regulation of Certain Leverage Transactions, 49 Fed. Reg. 5498, 5501 (1984); Transcript at 22, 31, 44, 75, Meeting of Commodity Futures Trading Commission (June 12, 1984) (regulation of short sales of leverage).

123/ *See, e.g.*, Comments of U.S. Department of Justice, CFTC Docket No. 83-28, at 25-26 (Aug. 22, 1983); Comments of Merrill Lynch Futures Inc. on Proposed Regulations to Govern Leverage Contracts and Transactions, CFTC Docket No. 83-28, at 1, 2-6 (Aug. 22, 1983); Letter from C. Nastro, Executive Vice Pres., Shearson Lehman/American Express Inc., to S. Phillips, Chairman, CFTC (Oct. 25, 1984).

124/ 7 U.S.C. § 2 (1982).

125/ The legislative history of the leverage provisions is detailed in the Appendix, *infra*.

126/ *See* Commodity Exchange Act § 19(b), 7 U.S.C. § 23(b) (1982); 17 C.F.R. § 31.1-31.2 (1984).

127/ *See* Commodity Exchange Act § 19(c), 7 U.S.C. § 23(c) (1982).

128/ *See id.* § 19(a), 7 U.S.C. § 23(a) (1982).

129/ *See* Futures Trading Act of 1982, Pub. L. No. 97-444, § 206, 96 Stat. 2294, 2301.

130/ *See* H.R. Rep. No. 964, *supra* note 122, at 50-51.

131/ *See*, *e.g.*, Transcript at 9-10, 15-16, 22, 24-26, 38-39, 44, 57-62, Meeting of Commodity Futures Trading Commission (June 12, 1984) (regulation of "short sales" leverage transactions).

132/ *See* 17 C.F.R. §§ 31.4-31.24 (1984), *as amended by* 50 Fed. Reg. 22 (1985). The regulations require registration of so-called leverage commodities, which registration will be granted only for registered "leverage transaction merchants," where there is a widely accepted and broadly disseminated commercial or retail cash price series for the commodity, where the commodity is readily salable by leverage customers in normal commercial or retail channels, and where the terms and conditions of the contracts in the leverage commodity are consistent with the Commodity Exchange Act and Commission regulations. *Id.* § 31.6. The regulations impose minimum financial, *id.* §§ 31.7, 31.9; cover, *id.* § 31.8; and customer-fund segregation requirements, *id.* § 31.12; as well as recordkeeping, *id.* §§ 31.14, 31.17; reporting, *id.* §§ 31.13, 31.15, 31.16; and disclosure requirements, *id.* § 31.11. The regulations forbid FCM's from engaging in leverage transactions, *id.* § 31.22; and require that leverage transaction merchants offer to repurchase contracts they are selling, *id.* § 31.10. The regulations also forbid a leverage transaction merchant from liquidating a contract because of a margin deficiency without first making a margin call, *id.* §§ 31.18; forbid representations that the Commission approves of the merchant or his contracts, *id.* § 31.19, as well as representations of guarantees against loss, *id.* § 31.20; and give a leverage customer entering a leverage contract for the first time with a particular merchant a three-day cooling-off period in which to rescind a contract, *id.* § 31.23.

133/ *See* 17 C.F.R. § 31.4(w) (1984), *as amended by* 50 Fed. Reg. 22, 27 (1985).

134/ *See* 50 Fed. Reg. 22 (1985).

135/ *See* Commodity Exchange Act § 19(b), 7 U.S.C. § 23(b) (1982).

136/ *See* Commodity Exchange Act § 2(a)(1)(B), 7 U.S.C. § 2a (1982).

137/ *See* Commodity Exchange Act § 19(c), 7 U.S.C. § 23(c) (1982):

> Notwithstanding any other provision of this section, the Commission may prohibit any transaction for the delivery of any commodity

> under a standardized contract described in subsection (a) of this section that is not permitted by the rules, regulations and orders of the Commission in effect on December 9, 1982, if the Commission determines that any such transactions would be contrary to the public interest.

138/ *See* Appendix, Legislative History of Leverage Regulation.

139/ *See supra* notes 22-23 and accompanying text.

140/ *See* Transcript at 44, Meeting of Commodity Futures Trading Commission (June 12, 1984) (remarks of Commissioner William Seale); *supra* note 98 and accompanying text.

141/ H.R. Rep. No. 964, *supra* note 122, at 51.

142/ H.R. Rep. No. 565, *supra* note 16, pt. 1, at 44.

143/ *See id.*; Commodity Exchange Act § 12(e), 7 U.S.C. § 16(e) (1982).

144/ *See* State of Texas v. Imperial Capital, Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 22,307, at 29,515 (N.D. Tex. Aug. 6, 1984) (defendants claim CFTC leverage definition does not limit parameters of CFTC's exclusive jurisdiction over all leverage contracts).

In its OGC Interpretative Letter No. 84-1 (June 1, 1984), the Commission's Office of General Counsel announced its view that leverage contracts that have terms shorter than ten years are not "leverage" contracts as defined by the Commission, *see* 17 C.F.R. § 31.4(w) (1984), *as amended by* 50 Fed. Reg. 22, 27 (1985); that they are thus "not subject to regulation by the Commission under Section . . . 19," *see* Commodity Exchange Act §§ 2(a)(1)(A), 12(e)(2), 7 U.S.C. §§ 2, 16(e)(2) (1982); and that states therefore could initiate actions against merchants of such contracts.

145/ *See* CFTC v. Smythe-Wheatley, Ltd., Civ. No. 84-243- PHX-WPC (D. Ariz. 1984); CFTC v. Brazier Corp., Civ. No. 84-3064 RMT (MCX) (C.D. Cal. 1984); CFTC v. Van Overmeer, Civ. No. 84-1463 GT(M) (S.D. Cal. 1984).

146/ *See generally* Commodity Investment Fraud, S. Rep. No. 495, 97th Cong., 2d Sess. (1982).

147/ *See* Commodity Exchange Act §§ 5(a), 5(c), 5(d), 5(g), 7 U.S.C. §§ 7(a), 7(c), 7(d), 7(g) (1982); 17 C.F.R. pt. 5, App. A (1984).

148/ *See* Commodity Exchange Act §§ 5a(8), 5a(12), 7 U.S.C. §§ 7a(8), 7a(12) (1982); 17 C.F.R. § 1.38 (1984).

149/ *1974 Hearings*, *supra* note 4, at 750 (statement of M. Martin Rom, Chm., IPMC) ("play havoc with the market").

150/ *See*, *e.g.*, *Conservation Subcomm. Hearings*, *supra* note 14, at 428 (statement of Louis Carabini, President, Monex) ("immediate destruction of the leverage industry").

151/ *See*, *e.g.*, Rulemaking Comments of Monex, *supra* note 15, at 2 ("rapid, if not immediate, destruction of the entire leverage industry"). Indeed, the leverage industry has not embraced the new regulations gladly. The CFTC has received several petitions for exemption from many key requirements of the regulations. One merchant is challenging the regulations in court. First National Monetary Corp. v. CFTC, Civ. No. 84-2808 (E.D. Mich. filed June 14, 1984). Another was charged by the Commission staff with executing leverage contracts in unregistered leverage commodities after the regulations were promulgated. Complaint at 1-7, *In re* Monex Int'l, Ltd., No. 84-50 (CFTC Sept. 27, 1984). This case was settled, with the Commission finding that the merchant violated the CEA. *In re* Monex Int'l, Ltd., 2 Comm. Fut. L. Rep. (CCH) ¶ 22,413 (CFTC Nov. 8, 1984) (opinion and order of settlement with remedial sanctions).

152/ Pub. L. No. 93-463, § 217, 88 Stat. 1389, 1405. This discussion follows the more detailed legislative history of the various leverage provisions in T. Russo, *supra* note 97, §§ 8.03-8.09, at 8-4 to 8-23. *See also* P. Johnson, *supra* note 12, §§ 1.08, 1.75-1.78; 44 Fed. Reg. 6737 (1979).

153/ Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, § 217(a), 88 Stat. 1389, 1405. The full text of section 217 was as follows:

> (a) No person shall offer to enter into, enter into, or confirm the execution of any transaction for the delivery of silver bullion, gold bullion, or bulk silver coins or bulk gold coins, pursuant to a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract contrary to any rule, regulation, or order of the Commodity Futures Trading Commission designed to insure the financial solvency of the transaction or prevent manipulation or *fraud: Provided*, That such rule, regulation, or order may be made only after notice and opportunity for hearing. If the Commission determines that any such transaction is a contract for future delivery within the meaning of the Commodity Exchange Act, as amended, such transaction shall be

> regulated in accordance with the provisions of such Act.
>
> (b) The provisions of section 9(c) of the Commodity Exchange Act, as amended, shall be applicable with respect to persons who violate the provisions of this section.

Id.

154/ H.R. Rep. No. 1383, supra note 97, at 39.

155/ Extend Commodity Exchange Act: Hearings on H.R. 10285 Before the Subcomm. on Conservation and Credit of the House Comm. on Agriculture, 95th Cong., 2d Sess. 69-71 (1978).

156/ See generally T. Russo, supra note 97, § 8.06, at 8-10.

157/ Futures Trading Act of 1978, Pub. L. No. 95-405, § 23, 92 Stat. 865, 876. The text of section 19 as enacted was as follows:

> (a) No person shall offer to enter into, enter into, or confirm the execution of, any transaction for the delivery of any commodity specifically set forth in section 2(a) of this Act prior to the enactment of the Commodity Futures Trading Commission Act of 1974 under a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract, or under any contract, account, arrangement, scheme, or device that the Commission determines serves the same function or functions as such as standardized contract, or is marketed or managed in substantially the same manner as such a standardized contract.
>
> (b) No person shall offer to enter into, enter into, or confirm the execution of any transaction for the delivery of silver bullion, gold bullion, or bulk silver coins or bulk gold coins, under a standardized contract described in subsection (a) of this section, contrary to any rule, regulation, or order of the Commission designed to ensure the financial solvency of the transaction or prevent manipulation or fraud: Provided, That such rule, regulation, or order may be made only after notice and opportunity for hearing.
>
> (c) The Commission may prohibit or regulate any transactions, under a standardized contract described in subsection (a) of this section, involving any other commodities under

> such terms and conditions as the Commission shall initially prescribe by October 1, 1979: Provided, That any such order, rule, or regulation may be made only after notice and opportunity for *hearing: Provided further*, That the Commission may set different terms and conditions for such transactions involving different commodities.
>
> (d) If the Commission determines that any transaction under subsections (b) and (c) of this section is a contract for future delivery within the meaning of this Act, such transaction shall be regulated in accordance with the applicable provisions of this Act.

158/ S. Rep. No. 1628, 95th Cong., 2d Sess. 27 (1978).

159/ *Id.* at 28.

160/ Memorandum from Office of General Counsel to Commodity Futures Trading Commission (Sept. 5, 1978), *reprinted in* [1977-80] Comm. Fut. L. Rep. (CCH) ¶ 20,772, at 23,164-70.

161/ S. Rep. No. 1628, *supra* note 158, at 28.

162/ Report of the Advisory Committee on Market Instruments to the Commodity Futures Trading Commission, *reprinted in part in* [1975-77] Comm. Fut. L. Rep. (CCH) ¶ 20,192 (July 16, 1976).

163/ *See id.* at 23-24 (not reported in CCH).

164/ T. Russo, *supra* note 97, § 8.06, at 8-9 & n.9, *citing* Comm. Fut. L. Rep. (CCH), Rep. No. 33, at 2 (Oct. 22, 1976).

165/ *Id.* at 8-9 & n.10, *citing* Comm. Fut. L. Rep. (CCH), Rep. No. 61, at 3 (Nov. 23, 1977).

166/ Division of Enforcement, Commodity Futures Trading Commission, Survey of Leverage Trading (Apr. 19, 1978).

167/ B. Imel, Acting Chief Economist, Commodity Futures Trading Commission, Economic Considerations in Classifying Leverage Transactions as Contracts for Future Delivery (May 8, 1978).

168/ *See supra* note 160 and accompanying text.

169/ *See* 17 C.F.R. § 31.1 (1984). This regulation imposes a moratorium upon entry into the business of offering and selling leverage contracts involving gold or silver bullion or bulk coins. This was followed in 1979 by a moratorium on entry into the business of selling leverage contracts involving all other commodities. See 17 C.F.R. § 31.2 (1984).

170/ See Regulation of Leverage Transactions as Contracts for Future Delivery or Otherwise, 44 Fed. Reg. 13,494 (Mar. 12, 1979).

171/ See Regulation of Leverage Transactions as Contracts for Future Delivery, 44 Fed. Reg. 44,177 (July 27, 1979).

172/ Id.

173/ Conservation Subcomm. Hearings, supra note 14, at 434-36 (letter to CFTC Chm. James Stone from Congs. Thomas Foley, William Wampler, Ed Jones, and Edward Madigan); Senate Subcomm. Hearings, supra note 22, at 677-78 (letter to CFTC Chm. James Stone from Sens. Herman Talmadge and Jesse Helms). The Senate committee letter stated:

> In the 1978 Act, Congress expanded and strengthened the basic authority of the Commission to regulate the leverage business. We did so despite the Commission's request to be relieved of this responsibility. In light of the attention that Congress gave to the issue of leverage contract regulation and the legislative history created in the passage of the 1974 and 1978 Acts, we are especially concerned over proposed action by the Commission appearing to legislate on a question that Congress has already resolved in favor of substantive regulation.
>
> Congress created the Commission to protect the public interest in the commodities area. However, your letter states, in effect, the Commission's intention to prohibit a substantial area of ongoing economic activity. Such action could cause irreparable harm not only to the affected firms and their employees, but to their thousands of public customers as well. The Commission's January 1 ban of this business appears to be based on the Commission's own regulatory convenience -- the very worst kind of overregulation.
>
> Your letter states the Commission's intent to go forward with its determination "in the absence of a statutory change." We feel the Commission is gravely misguided in seeking to impose a deadline on Congress, especially since Congress has already made its intent clear.

Id. at 678.

174/ The Commission issued a brief release on November 27, 1979, announcing that it was postponing the effective date of the July proposal from January 1 to June 30, 1980. Postponement of

Effective Date of Regulation of Leverage Transactions as Futures Contracts, 44 Fed. Reg. 69,304 (Dec. 3, 1979). In late May 1980 the four members of the Commission again voted on the July 1979 proposal; the vote was a tie, and as a result the Commission determined to have the staff develop interim regulations and to postpone the effective date of the July proposal to October 1, 1982. T. Russo, supra note 97, § 8.07, at 8-17 & n.12, citing Comm. Fut. L. Rep. (CCH), Rep. No. 125 (June 4, 1980).

175/ See, e.g., S. 2109, § 25, 97th Cong., 2d Sess., at 49-50 (Feb. 11, 1982), reprinted in Comm. Fut. L. Rep. (CCH), Special Rep. 1, at 49-50 (Feb. 26, 1982). This bill was introduced in a form substantially similar to that proposed by the CFTC.

176/ See, e.g., S. Rep. No. 384, supra note 8, at 52 ("No further study is necessary.")

177/ H.R. Rep. No. 565, supra note 16, pt. 1, at 108: "The Committee intends for the Commission to regulate leverage transactions, not to ban them."

178/ S. Rep. No. 384, supra note 8, at 52-53. The Senate Committee expressed its intention that the Commission regulate leverage transactions and not ban them, adding that "the authority of section 19(d) is not to be misconstrued and exercised as a substitute for the regulation of leverage transactions." Id. at 52-53.

179/ Commodity Exchange Act § 19(c), 7 U.S.C. § 23(c) (1982). The conference committee announced its intention that the Commission issue comprehensive regulations as expeditiously as possible, but also that repeal of section 19(d) was not to be construed as limiting the Commission's authority to take action against transactions "masquerading as 'leverage' contracts." H.R. Rep. No. 964, supra note 122, at 50-51.

The text of section 19, 7 U.S.C. § 23 (1982), as amended, is as follows:

> (a) No person shall offer to enter into, enter into, or confirm the execution of, any transaction for the delivery of any commodity specifically set forth in section 2 of this title prior to October 23, 1974, under a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract, or under any contract, account, arrangement, scheme, or device that the Commission determines serves the same function or functions as such a standardized contract, or is marketed or managed in substantially the same manner as such a standardized contract.

> (b) No person shall offer to enter into, enter into, or confirm the execution of any transaction for the delivery of silver bullion, gold bullion, or bulk silver coins or bulk gold coins, under a standardized contract described in subsection (a) of this section, contrary to any rule, regulation, or order of the Commission designed to ensure the financial solvency of the transaction or prevent manipulation or *fraud: Provided*, That such rule, regulation, or order may be made only after notice and opportunity for hearing.
>
> (c) The Commission shall regulate any transactions under a standardized contract described in subsection (a) of this section involving commodities described in subsection (b) of this section or any other commodities (except those commodities described in subsection (a) of this section) under such terms and conditions as the Commission shall prescribe by rule, regulation, or order made only after notice and opportunity for a hearing. The Commission may set different terms and conditions for such transactions involving different commodities. Notwithstanding any other provision of this section, the Commission may prohibit any transaction for the delivery of any commodity under a standardized contract described in subsection (a) of this section that is not permitted by the rules, regulations and orders of the Commission in effect on December 9, 1982, if the Commission determines that any such transactions would be contrary to the public interest.

180/ H.R. Rep. No. 964, *supra* note 122, at 50-51; H.R. Rep. No. 565, *supra* note 16, pt. 1, at 108-09; S. Rep. No. 384, *supra* note 8, at 52.

181/ 128 Cong. Rec. S13,099 (Oct. 1, 1982) (remarks of Sen. Helms).

182/ Letter from Rep. E (Kika) de la Garza, Chm., House Comm. on Agriculture, to Rep. Jamie L. Whitten, Chm., House Comm. on Appropriations, at 1-2 (Sept. 12, 1984).

183/ *Id.* at 2.

STATEMENT OF HARVEY KOCHEN, VICE PRESIDENT, INTERNATIONAL PRECIOUS METALS CORP.

This statement is submitted by Harvey Kochen on behalf of International Precious Metals Corporation ("IPMC"). IPMC is a leverage transaction merchant, registered under the Commodity Exchange Act (the "Act").

IPMC has approximately 200 employees and has offices in Fort Lauderdale, Florida, Boca Raton, Florida and Newport Beach, California. IPMC has been in the business of selling precious metals to the public through leverage contracts for over twelve years. At the present time, IPMC has approximately 2,400 leverage customers.

This is the fourth time in twelve years that IPMC has submitted material to Congress seeking a settled regulatory atmosphere in which to conduct our business. Notwithstanding the successful implementation of comprehensive regulations in 1982 as directed by Congress, the Commodity Futures Trading Commission has now proposed that Congress eliminate the regulation of leverage transactions from the Act. It is the Commission's view that leverage contracts and futures contracts are legally and economically indistinguishable and therefore do not justify separate statutory treatment.

This view is of course contrary to reality, contrary to the findings of Congress, as evidenced in the prior legislative history of the Act and its various amendments, and is also contrary to the findings of the Commission's own Advisory Committee in 1976.

As a legitimate business enterprise serving the demands of a segment of the investing public for over ten years, IPMC has faced continuing frustrations and has incurred very substantial expense due to the unsettled regulatory environment regarding leverage contracts. The history of the regulation of leverage contracts reflects the continuing reluctance of the CFTC to adhere to the mandates of Congress and to regulate (rather than prohibit) leverage contracts as a federally regulated commodity instrument. A brief review of that history will help demonstrate that the CFTC's present position is entirely inappropriate.

HISTORY OF THE REGULATION OF LEVERAGE CONTRACTS

In 1974, Congress included within the charter of the new CFTC the regulation of companies engaged in the sale of commodities through leverage contracts. Section 217 prohibited any person from entering into a leverage transaction contrary to any CFTC regulation designed to ensure the financial solvency of the transaction or to prevent manipulation or fraud. The Conference report clearly directed the new CFTC to regulate these transactions.

Shortly after the CFTC was created in April 1975, it adopted a stopgap antifraud regulation for leverage transactions. IPMC strongly supported this regulation and in comments to the CFTC urged in addition that the Commission "move swiftly to adopt additional comprehensive regualtions under Section 217".

On August 20, 1975, the CFTC proposed a temporary rule to regulate leverage transactions pending a more comprehensive review of the industry, but the proposal was never acted upon. In the meantime, the CFTC empaneled a seventeen-person Advisory Committee to study and make recommendations on the Commission's jurisdiction over futures, forward and leverage contracts.

On July 16, 1976, the CFTC Advisory Committee on Market Instruments, after almost a year of study, including several public hearings, published an exhaustive report including findings that leverage transactions (a) are distinct from traditional exchange-traded futures transactions and should not be regulated as such futures contracts, (b) are not inherently fraudulent or manipulative, and (c) could not and should not be prohibited. The Committee also proposed specific and comprehensive recommendations to the CFTC for leverage transaction regulations.

Shortly thereafter, on September 18, 1976, the CFTC's General Counsel endorsed the Advisory Committee findings and recommendations. The following week, on October 4, 1976, the CFTC considered the findings and voted to regulate leverage transactions in accordance with the recommendations of the Advisory Committee. At that meeting, the Commission directed its staff to prepare regulations for publication.

Over a year later, at a meeting held November 8, 1977, the CFTC discussed the status of the proposed regulations and decided more "study" of the leverage business was necessary in order to help the Commission draw a distinction between leverage contracts and futures contracts. The staff was directed to conduct the study and return to the Commission "within four weeks". But no study was returned in four weeks.

In another three months, before the staff "study" was finished and in an abrupt reversal of its course, the CFTC asked this Committee to repeal Section 217. The CFTC Vice Chairman, on February 21, 1978, summarized the Commission's position on reauthorization of the leverage authority saying, "Frankly, I think the judgment was made by the Commission that leverage was not worth the trouble we were going through in trying to define it. Therefore I think we are coming back to you and asking you to take us off the hook."

During that reauthorization, IPMC and its major competitors asked Congress not to reopen the "regulatory gap" that had existed prior to 1974 by repealing Section 217, but to direct the CFTC promptly to regulate the leverage business. On August 17, 1978, House and Senate conferees rebuffed the Commission's proposal, agreed to expand its jurisdiction over leverage transactions involving all commodities, and directed the Commission once again to regulate leverage transactions. The draft Conference Report stated succinctly enough, "It is the intent of the conferees that the Commission act expeditiously . . . to regulate . . . leverage transactions in gold and silver."

Nevertheless, after the Committee had adjourned but before the report had been adopted, and in a last minute effort to circumvent the action of the conferees, the Commission deliberately put Congress on notice that all leverage transactions could be banned by the CFTC utilizing its authority under proposed section 19(d) as an alternative to regulating the industry. This, they reasoned, would force Congress "to clarify" its intentions with respect to Section 19.

In response, language was added to the Conference Report stating: "In this regard, the Commission's authority to determine that any gold or silver leverage contract is a contract for future delivery . . . is not to be casually exercised as a substitute for the regulation of that leverage contract . . . The Conferees did not contemplate, based on prior represenatations by the Commission, that the Commission would classify all gold and silver leverage contracts as contracts for future delivery."

The Commission failed to follow this instruction. First, on December 5, 1978, the CFTC took final action on a "temporary" moratorium on the entry of new firms into the gold and silver leverage transaction business. The "temporary" moratorium was made effective June 1, 1978, and has not been lifted to this day, so that the entry of new competition into our business has been prevented. On February 2, 1979, the CFTC imposed another "temporary" moratorium on the sale of any commodities other than gold or silver by either existing leverage firms or any new firms. This moratorium also remains in effect today, freezing even product competition among the few companies allowed to engage in the leverage business.

In a good faith effort to expedite the Commission's compliance with Congress' instruction to regulate, on February 14, 1979, two major leverage firms, IPMC and Monex International Ltd., submitted to the CFTC a joint rulemaking position including comprehensive proposed leverage regulations. In March, notice of the proposed ban—the determination that leverage contracts are futures contracts within the meaning of the Act—was published by the CFTC. Subsequently, notice of the availability of the industry petition was published in April. In the meantine, in spite of overwhelmingly negative comments received in response to the proposal that leverage contracts were actually futures contracts, the CFTC published notice on July 27, 1979, of its intention so to determine, effective January 1, 1980. The Commission, without any consideration of the impact upon thousands of leverage customers, acknowledged that this action would constitute a ban on all leverage transactions.

Since it was apparent the Commission was still ignoring the instructions it had received, Chairman Talmadge and Senator Helms on behalf of this Committee, and Chairman Foley and Representatives Wampler, Jones and Madigan, on behalf of the House Committee on Agriculture, sent letters to the CFTC on November 15 and 16, 1979, respectively, reminding the Commission of its regulatory mandate under Section 19, urging the Commission to reconsider its proposed ban, and warning the Commission against trying to ignore its own deadline on Congress.

In response to this letter, the CFTC met on December 3, 1979 and voted to postpone the effective date of its proposed ban on leverage transactions until June 30, 1980. On May 28, 1980, the CFTC voted again to postpone its proposed ban, this time until October 1, 1982. Purportedly, this would give Congress yet another opportunity to clarify its intentions. The CFTC directed its staff to develop "interim" regulations to protect the public in the meantime.

These regulations were to be published and effective not later than December, 1980, but once again the staff failed to act. Then, at a meeting on April 28, 1981, almost a year later, the CFTC finally considered specific proposals for "interim" regulations. The Commission approved them and directed the staff to prepare a Federal Register notice publishing the specific regulations.

As part of the 1982 reauthorization process of the CFTC, Congress again directed the CFTC to regulate leverage transactions as a distinct category of commodity transactions and to regulate the leverage transaction business not subject to CFTC moratoria. In response, the CFTC finally promulgated extensive regulations (denominated as "interim" regulations by the CFTC) governing leverage transactions, which became effective in June 1984. Although onerous, the leverage transaction rules have successfully provided a workable regulatory framework in which leverage customers have been adequately protected and the leverage transaction merchants have continued in business.

With these regulations in place and operating successfully, it is incongruous for the CFTC to again return to Congress and ask that leverage contracts be banned as off-exchange futures contracts. Moreover, it has been demonstrated time and time again that leverage contracts are not the same as futures contracts.

LEVERAGE CONTRACTS ARE NOT THE SAME AS FUTURES CONTRACTS

Since the adoption of the Commodity Futures Trading Commission Act of 1974, Congress has recognized that leverage contracts are different instruments from futures contracts. Congressional recognition of the critical characteristics of leverage contracts was most clearly expressed in the Report of Senate Committee on Agriculture, Nutrition and Forestry, S. Rep. 850, 95th Cong., 2d Sess. 26 (1978), as follows:

"Generally, the leverage contract currently in use is an agreement for the purchase or sale of a contract for the delivery at a later date of a specified commodity in a standard unit and quality, or the close-out of the contract by an offsetting transaction. The principal characteristics of the contract include: (1) standard units, quality, and terms and conditions; (2) payment and maintenance of 'margin'; (3) close-out by an offsetting transaction or by delivery, after payment in full; and (4) no right or interest in a specific lot of the commodity. The leverage dealer is the principal to every transaction and functions as a market maker. The leverage dealer, however, does not guarantee a repurchase market and further reserves the right to cease operating as a market maker or broker for the customer. Most customer commitments are covered or 'hedged' in futures, forwards, or physical inventory; most physical inventory, however, is encumbered through bank loans. Leverage contract bid/ask prices are determined by dealer adjustments to spot and futures market quotations."

There are clear legal distinctions between leverage contracts and futures contracts: a leverage contract is a contract to purchase a commodity for delivery at a later date at any time during a specified period, and is margined with a down payment that reduces the unpaid balance; a futures contract, on the other hand, is a contract to purchase a spot contract at a specified time, and is margined with a performance deposit.

There are also significant economic differences between the two. The futures contract is designed primarily as a hedging vehicle and not for delivery. The buyer of a long futures contract chooses the delivery month when the contract is entered into; and then it is the seller, not the purchaser, who controls the actual delivery. The leverage contract is designed for flexible delivery. The buyer of a leverage contract makes the purchase and then decides when to take delivery at any time during the extended period. The choice of time and place of delivery belongs to the leverage contract buyer.

Moreover, leverage contract pricing is based on the current spot or cash market, as opposed to futures pricing which is based on a deferred delivery month. Leverage contract prices are based on discovery from other verifiable, publicly available market sources, validated with an immediate time-stamping audit trail. Leverage contract prices are not restricted by limit moves, which can trap an unwary investor.

Leverage contracts are also treated in a different manner than futures contracts for tax purposes, in recognition of the significant economic and legal differences between the two.

There are numerous other distinctions between leverage contracts and future contracts. We believe that the Report of the Advisory Committee on Market Instruments to the Commission entitled "Recommended Policies on Futures, Forwards and Leverage Contracts and Transactions" includes a generally accurate comparison, at pages 18-22, of certain significant elements of futures and leverage contracts. That chart is attached as Exhibit A.

On the basis of the Advisory Committee Report, it was determined that a separate regulatory scheme applicable to leverage contracts should be adopted. Many of the Advisory Committee's recommendations are now embodied in the leverage transaction rules.

A further explanation of significant economic and other distinctions between leverage contracts and futures contracts is contained in the study entitled "The Commodity Leverage Contract: An Economic Analysis," prepared for IPMC in 1978 by Dr. Roger W. Gray and Dr. David J.S. Rutledge, attached as Exhibit B.

The CFTC's attempt to avoid continuing responsibility for regulation of leverage contracts might be understandable if it could be demonstrated that the public interest would be better served by delegating this responsibility to the states as suggested by the CFTC. There are two fundamental flaws in this position—first, the federal regulation of leverage transaction is working, and second, the regulation of leverage contracts is properly a matter within the exclusive jurisdiction of the CFTC.

FEDERAL REGULATION OF LEVERAGE TRANSACTIONS IS WORKING EFFECTIVELY

Prior to the issuance of the regulations in 1984, IPMC on a voluntary basis followed practices which included, among others, 100 percent cover of its delivery obligations, complete segregation of customer funds and disclosure of the terms and conditions of its leverage contract. Unfortunately, some commodities merchants selling similar commodity instruments did not follow these practices and a number of customers suffered as a result of the financial failure of these merchants or their fraudulent practices.

With the adoption of the comprehensive federal leverage regulations, the investing public is now protected in these regulated off-exchange transactions. These leverage customer protections include:

1. A minimum adjusted net capital requirement of $2,500,000, with an early warning level of $3,000,000;
2. Segregation of leverage customer funds from the funds of the leverage transaction merchant;
3. Cover by the leverage transaction merchant of its obligations to its customers;
4. The registration of the leverage transaction merchant, its principals, officers, directors, sales representatives and sales supervisory personnel, the leverage commodities it offers, and its customer disclosure documents and customer account agreement forms; and
5. Unprecedented commodity customer safeguards which include the limited right of rescission for a first-time customer, the limited right of re-establishment (without charges or fees) of a liquidated undermargined position and mandatory break-even disclosure.

These regulations, while unduly burdensome in certain respects, are clearly very effective in meeting their objectives of providing the customer with adequate disclosure, protection from manipulation and fraud and, most important, insuring the financial solvency of the transactions.

IPMC has not had a single customer reparations complaint or civil litigation suit brought against it by a leverage customer whose account has been established under these new leverage rules.

At the same time as the leverage rules have been implemented, IPMC is aware that certain commodities operations regulated only by the states have continued to engage in fradulent practices and have cost the investing public substantial sums of money. Customers of these operations have not been afforded the same regulatory protections as leverage customers and we think that the public interest is better served by maintaining the CFTC's exclusive jurisdiction.

THE REGULATION OF LEVERAGE CONTRACTS IS PROPERLY WITHIN THE EXCLUSIVE JURISDICTION OF THE CFTC

Leverage contracts are based upon the national and international commodities markets and are inherently a matter properly the subject of federal, rather than state, regulation. Withdrawing the federal leverage rules would effectively ban this business. This would not only be deterimental to the participants in the leverage industry, but would adversely affect thousands of investors who use leverage contracts as a means of investing in the precious metals market. IPMC could not convert its margin-type business into a physical cash delivery business to fit within state regulations to enable it to continue its operations, as suggested by the CFTC.

The CFTC-promulgated leverage transaction rules have provided a regulatory framework for this commodity contract. The states do not have effective laws to regulate this area, nor are they uniform. The states' legislation is designed to ban leverage transactions to the extent that they are not operated within the scope of federal regulations. Denying leverage transaction merchants exclusive federal regulation exposes leverage transaction to a plethora of inconsistent state regulations that would effectivley prohibit leverage transaction merchants from operating on a nationwide basis. It is disappointing to think that Congress would even consider adopting legislation that would withdraw an existing regulatory framework that is working, the result of which would deny the public the protection of these laws.

IPMC recognizes that the CFTC has scarce resources, and that the regulation of leverage contracts has been time-consuming and expensive. Accordingly we believe the public interest can be better served by the delegation by the CFTC of the direct regulation of the leverage industry to a designated self-regulatory organization, operating under the oversight of the CFTC.

The National Futures Association has acknowledged that it could regulate leverage transactions if directed to do so, and we believe the NFA is the appropriate organization since it already has the systems and personnel in place with respect to the regulation of every other federally-regulated category of commodity industry registrant that deals directly with the public. To the extent that regulatory responsibility for leverage would increase the NFA's operating costs, they could be recovered through membership fees for leverage merchants and their personnel. IPMC is certainly willing to pay its fair share of these costs and would welcome the opportunity to participate in the development of self-regulatory proposal for leverage merchants.

This brings up a final point. Due to the CFTC moratoria, the legitimate leverage industry currently consists of only two firms, IPMC and Monex International Ltd.

As observed in the Conference Committee in connection with the CFTC reauthorization in 1982, there moratoria are "inherently anticompetitive and thus contrary to the fundamental objectives of economic competition and the free marketplace." With effective regulations in place, there is no valid reason for continuing the moratoria and IPMC therefore urges Congress to direct the CFTC to lift these moratoria and permit entry of qualified firms as expeditiously as possible.

IPMC is grateful for this opportunity to express its views before this Committee. IPMC is willing to further assist this Committee in its evaluation of the leverage industry and will expeditiously respond to any such request.

EXHIBIT A.—A COMPARISON OF SOME SIGNIFICANT ELEMENTS OF FUTURES CONTRACTS, FORWARD CONTRACTS AND LEVERAGE CONTRACTS

	Futures	Forward	Leverage
Each contract is for the purchase and sale of a commodity to be delivered in the future. Different elements of each are as follows:			
1. Traded publicly through a central market place	Yes	No	No.
2. Pricing	Competitive open outcry	Private negotiation	Announced by one party.
3. Settlement by delivery	Minimally [1]	Usually	[2]
4. Cleared through and liability of parties assumed by central clearing house	Yes	No [3]	No.
5. Public participation	Substantially	Infrequently	Almost exclusively [4]
6. Trade participation	do	Predominantly	Almost never [4]
7. Contract terms:			
(a) Contract terms standardized by independent agency (e.g., exchange or association)	Mandatory	Optional [5]	No.
(b) Contract terms standardized by single contracting party	No	In some cases [6]	Yes.
(c) Quality	Standardized by exchange with premiums and discounts	As agreed to following negotiaiton by the parties	Standardized by each contract writer.
(d) Minimum lot size	Standardized by exchange	None	Do.

EXHIBIT A.—A COMPARISON OF SOME SIGNIFICANT ELEMENTS OF FUTURES CONTRACTS, FORWARD CONTRACTS AND LEVERAGE CONTRACTS—Continued

	Futures	Forward	Leverage
(e) Delivery points	do	As agreed to following negotiation by the parties.	Do.
(f) Delivery period	do	do	Do.
(g) Delivery date	Seller's option (subject to 7(f) above)	do	Buyer's option (subject to 7(f) above).
(h) Terms of payment	Standardized by exchange.	do	Standardized by each contract writer.
8. Independent quality verification (e.g., assaying, sampling, etc.)	Yes [7]	do	Not standardized but available at a fee.
9. Payment or deposit at time of contracting	Security deposit (original margin).	No [8]	Partial payment (long contract); security deposit (short contract).[9]
(a) Held by third party (e.g., clearing house and/or FCM segregated account)	Yes	No [3]	No.
(b) Paid or deposited by both parties	Yes	No [8]	No.
(c) Paid or deposited by one party only	No	No	Yes.
10. Additional payments or deposits, or withdrawals	Yes	No [8]	Yes [10]
(a) Daily "marking to market" (i.e., market value calculated daily)	Yes	No [8]	Yes
(b) Daily debit or credit for (a) alone	Yes	No [8]	In some cases.
(c) Settlement of daily debits or credits through a clearing house (sometimes referred to as a "variation margin")	Yes	No	No.
(d) Basis for additional payments or deposits, or withdrawals	Specified by rules of contract market and/or FCM.	No [8]	Specified by contract.[11]
11. Interest of other periodic fees	No	As agreed to following negotiation by the parties.	Yes [12]
12. Force majeure provisions	Standardized by exchange.	do	Standardized by each contract writer.

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[1] In some commodities with light trading volume, a relatively high proportion of contracts initially traded culminate in delivery.

[2] Experience to date is insufficient to make a meaningful generalization.

[3] Until recently, it was possible to clear and margin forward contracts in rubber through the Rubber Trade Association. That facility has been suspended for the time being.

[4] One dealer in leverage contracts stated at a subcommittee meeting that in rare instances leverage contracts are used by small miners, coin dealers and small jewelry manufacturers as a hedging device.

[5] Standardized trade association contracts are available (but not mandatory) in some commodities.

[6] Certain large dealers and industrial users prescribe their own standard forms, although the terms may be open to negotiation.

[7] Brand names, registration numbers and other evidences of quality may be accepted in lieu of independent quality verification.

[8] Athough forward contracts are not normally margined as such, the contracting parties may arrange for mutual or unilateral securing of open obligations, and such arrangements may include guarantees, performance bonds of letters of credit whereby third parties are involved.

[9] Peference to short leverage contracts should not be construed to mean that the Advisory Committee expresses any opinion whether such contracts are within the scope of § 217 of the CFTC Act.

[10] Normally the writer of a leverage contract does not make cash payments as the market moves against him, but in some cases he may make such payments to a particular customer to the extent he has previously received Item 10(a) payments from that customer.

[11] Withdrawals are permitted only in some cases subject to contract.

[12] The Advisory Committee expresses no opinion whether periodic fees, whatever called, constitute interest.

Exhibit B—The Commodity Leverage Contract: An Ecomomic Analysis

(By Roger W. Gray, professor, Food Research Institute, Stanford University and David J.S. Rutledge, associate professor, Macquarie University, Sydney, Australia and visiting associate professor, Food Research Institute, Stanford University—June 1978)

1. INTRODUCTION

The leverage contract is a relative newcomer to the investment scene in the United States. It has been described in the following terms: "Generally, the leverage contract currently in use is an agreement for the purchase or sale of a contract for the delivery at a later date of a specified commodity in a standard unit or quality, or the close-out of the contract by an offsetting transaction. The principle characteristics of the contract include: (1) standard units, quality, and terms and conditions; (2) payment and maintenance of margin; (3) close-out by an offsetting transaction or by delivery, after payment in full; and (4) no right or interest in a specific lot of the commodity."[1]

According to a recent staff survey conducted by the CFTC, trading in leverage contracts in silver and gold may account for an open customer commitment of as much as $100 to $150 million. Additionally, there is a growing volume of leverage transactions in other commodities such as platinum, copper, foreign currency and investment diamonds.[2]

Relatively little is known about the market structure and conduct of the leverage contract industry. Under Section 217 of the Commodity Exchange Act (as amended) the CFTC was empowered to regulate leverage transactions in silver and gold. In August 1975 the Commission established an Advisory Committee on Definition and Regulation of Market Instruments to, inter-alia study and make recommendations on the definition and regulation of leverage transactions. The deliberations of this Committee were somewhat hampered by lack of hard data relating to this industry, but it nevertheless suggested a framework within which the industry might be regulated by the Commission.

To the present time the Commission has not promulgated regulations for these contracts. Indeed in reauthorization hearings before Congress earlier this year the Commission sought to have Section 217 repealed. Further, in an internal memorandum dated May 8, 1978, the Acting Chief Economist of the Commission argued that leverage contracts are essentially futures contracts, a finding which, if accepted, would have significant implications for the industry and its regulation. Most recently the Commission last month imposed a moratorium on new firms entering the industry.

The present study is intended to shed some further light on the operation of this industry. In particular it considers the following questions:

(a) What, if any, are the peculiar economic characteristics of the leverage contract which distinguish it from other forms of investment in commodities?

(b) How does the leverage contract compare to other forms of investment from the viewpoint of the investor?

(c) What is the economic basis of the fee structure used by firms in this industry?

(d) How are prices of leverage contracts determined?

(e) What practices are followed with respect to such things as coverage, segregation of accounts and compliance?

In addressing these questions we have relied not only on the general body of literature in commodity economics but also on data provided by International Precious Metals Corporation (IPMC), a leading firm in the industry. Our analysis and conclusions are therefore limited to the extent that IPMC's operations may not be representative of the industry as a whole. In particular, as IPMC deals only in long leverage contracts, and only in gold and silver bullion and coins, our analysis may not apply directly to short contracts and to other commodities.

2. THE LEVERAGE CONTRACT AS AN INVESTMENT MEDIUM

In a later section of this study we shall discuss the nature of the leverage contract as an economic instrument pointing out the ways in which it differs from other forms of forward contracts. For the moment, however, we focus on the potential usefulness of the leverage contract to the purchaser of such a contract, and compare it with other forms of investment available to him. Our analysis is restricted to gold and silver, indeed, for the most part, to gold and silver bullion.

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[1] Commodity Futures Trading Commission, Press Release, April 27, 1978, pp.1-2.

[2] Ibid., p. 1.

Leverage contracts provide a means for the small trader to invest in gold and silver. One might well question at the outset the rationale for such investment, although this issue goes beyond the purpose of the present study. Nevertheless it is clear to even the most casual observer that precious metals do provide some measure of protection against the ravages of inflation. It would be a brave person who would argue that significant inflation is unlikely to be a persistent phenomenon for the indefinite future. In any event, even in the absence of the leverage contract, there are several means whereby investors can include gold and silver coins in their portfolios.

While addressing this issue, however, it may be appropriate to point out one aspect which is often overlooked. In standard treatments of investment analysis [3] much is made of the desirability of including in one's portfolio assets whose returns are negatively correlated with each other. This enables the investor to reduce the risk associated with a given expected portfolio return or, equivalently, to increase the expected return associated with a given degree of risk. In pursuing this theme we correlated movements in the Dow Jones Industrials Average with the spot price of gold, finding a correlation of −0.843.[4] This suggests that precious metals may have a role to play in the portfolio of even a relatively small investor.

Such an investor has available three alternative courses of action:

(a) Outright purchase;
(b) Purchase of futures contracts; and
(c) Purchase of a leverage contract.

Of these, outright purchase has the advantage of virtually no minimum purchase size,[5] but the disadvantages of little or no leverage and possible high transactions cost in the event of resale.

A comparison of futures contracts and leverage contracts, as we shall see below, involves more subtle distinctions but nevertheless very real ones from the viewpoint of the investor. Futures contracts in gold and silver bullion and coins are traded on several organized exchanges in North America. Details of the major contracts are summarized in Table 1. For purposes of comparison, Table 2 reports the minimum purchase quantities available in leverage contracts from IPMC. Clearly, smaller quantities are available via leverage contracts although this comparison is misleading because each involves a different degree of leverage. In fact, the initial capital requirement is approximately the same for each form of investment. At current market values an initial outlay of approximately $950 is required for the purchase of a leverage contract in silver bullion. To purchase a silver futures contract an initial outlay of approximately $1,060 is required, except for the Mid-America Commodity Exchange where the corresponding figure is approximately $550. Very similar figures apply to gold. Thus, with the exception of futures transactions on the Mid-America Exchange, much the same initial outlay is required for both futures and leverage transactions. It may be noted, however, that trading in gold and silver at the Mid-America Exchange is considerably less active than at the major exchanges, with the consequence that any given transaction is more likely to have a price effect. Furthermore the above calculations do not take into account the fact that many brokerage houses require a customer to deposit an initial sum of several thousand dollars before servicing his futures transactions.

[Tables 1 and 2 follow:]

TABLE 1.—MAJOR FEATURES OF FUTURES CONTRACTS IN GOLD AND SILVER [1]

Exchange	Gold		Silver	
	Contract size [2]	Average monthly trading [3] volume, Jan. 1978–Apr. 1978 (contracts)	Contract size	Average monthly [3] trading volume, Jan. 1978–Apr. 1978 (contracts)
Comex	100 oz	211,283	5,000 oz	319,789
IMM	100 oz	182,352	(4)	

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[3] For example, W.F. Sharpe, Investments, Prentice-Hall 1978.

[4] Similarly large negative correlations were found between the price of gold and other major stock market indices. The data on which these figures are based are 129 weekly observations from Janaury 1975 to June 1977.

[5] For example IPMC requires a minimum cash purchase of $500.

TABLE 1.--MAJOR FEATURES OF FUTURES CONTRACTS IN GOLD AND SILVER [1]—Continued

Exchange	Gold		Silver	
	Contract size [2]	Average monthly trading [3] volume, Jan 1978–Apr 1978 (contracts)	Contract size	Average monthly [3] trading volume, Jan 1978–Apr 1978 (contracts)
CBT	3 kilo	393	5,000 oz	232,134
Mid-America	1 kilo	390	1,000 oz	35,507
Winnipeg	400 oz	1,284	(4)	

[1] Futures contracts for U.S. Silver Coins are traded on IMM and Mid-America, and for Gold Bullion on New York Mercantile Exchange. However, these contracts are relatively inactive at the present time.

[2] 1 kilo equals 3.11 troy ounces.

[3] Data on trading volume for Comex, IMM, CBT and Mid-America obtained from Futures Industry Association Monthly Bulletin No. 3380. For Winnipeg, data obtained from Wall Street Journal.

[4] No silver contract traded.

TABLE 2.—*IPMC leverage contracts: Minimum purchase quantities*

Product	*Minimum purchase quantity*
Silver	500 oz.
Gold	0.5 kilo.
Silver clad coins	2 bags.
U.S. 90% silver coins	1 bag.
U.S. 20 dollar coins	20 coins.
British sovereign coins	80 coins.
Mexican 50 peso coins	20 coins.
Krugerrand coins	Do.

While the minimum initial outlay is similar for the two instruments, the risk exposure is most certainly not. Since the futures contract is more highly levered than the leverage contract, an adverse price movement will erode the capital position of a futures trader two or three times as fast as that of the leverage contract customer. It is presumably easier, therefore, for the small investor to manage his overall risk exposure via a leverage contract than by trading futures.

Another major respect in which futures and leverage contracts differ from the investor's viewpoint is the time over which a position may easily be held. Leverage contracts are long-term contracts with delivery as far forward as ten or even twenty-five years. While it is true that relatively few contracts will be held for the full term the fact that the opportunity exists to do so cannot be dismissed as irrelevant. Furthermore, analysis of a sample of leverage contract accounts suggests that these contracts are held open considerably longer than are futures contracts.[6] While it may be possible to hold futures contracts over long periods of time it is frequently inconvenient to do so. Distant futures contracts are generally less actively traded than are nearbys. Furthermore, the contango structure in gold and silver futures markets reflects the term structure of interest rates which typically means that spreads widen as we go into the more distant contracts. This is demonstrated in Table 3. As a result it becomes more expensive to trade in distant rather than nearby futures. The alternative, of course, is to purchase the nearby future and to "roll over" the position as the delivery date approaches. However this involves additional commission expenses, while at the same time there is no guarantee that an unfavorable price movement will not occur at the time the position is moved forward.

TABLE 3.—*Comparison of nearby and distant futures price spreads*

A. IMM Gold Bullion, August 1976:	
December 1976 to September 1976:	
Per ounce	$0.791
Percent	0.725

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[6] A sample of 719 IPMC accounts on March 8, 1978 showed an average account life of 11.5 months.

March 1977 to December 1976:	
Per ounce	$1.255
Percent	1.142
June 1977 to March 1977:	
Per ounce	$1.832
Percent	1.622
B. Comex Gold Bullion, April 1978:	
August 1978 to June 1978:	
Per ounce	$2.242
Percent	1.273
December 1978 to October 1978:	
Per ounce	$2.374
Percent	1.314
April 1979 to February 1979:	
Per ounce	$2.689
Percent	1.450
C. CBT Silver Bullion, September 1976:	
December 1976 to October 1976:	
Per ounce	$1.624
Percent	.376
April 1977 to February 1977:	
Per ounce	$4.034
Percent	.922
October 1977 to August 1977:	
Per ounce	$4.693
Percent	1.042
D. Comex Silver Bullion, April 1978:	
September 1978 to July 1978:	
Cents per ounce	7.658
Percent	1.470
March 1979 to January 1979:	
Cents per ounce	8.237
Percent	1.513
July 1979 to May 1979:	
Cents per ounce	8.531
Percent	1.520

NOTE: Spreads are calculated from monthly averages of daily closing or settlement prices. Data are from IMM 1976-77 Yearbook, Chicago Board of Trade 1977 Statistical Annual and Wall Street Journal.

We do not wish to suggest that the leverage contract is inevitably a superior form of investment to the futures contract as far as the small investor is concerned. It suffers from several additional disadvantages. The leverage transaction merchant (LTM) is under no obligation to buy back the contract, although IPMC has always done so at its current bid price. Nevertheless in theory, there is no guaranteed resale market. Also, the leverage customer incurs further fees, a retail mark-up and the annual service fee, which means that a greater price increase is required for him to earn a profit. What we have argued, however, is that the leverage contract and the futures contract differ as an investment medium in a variety of ways and that consequently the leverage contract may on occasion better suit the requirements of some investors.

3. THE LEVERAGE FEE

One particular characteristic of the leverage contract which has caused confusion in the minds of some observers is the "leverage fee" or "carrying charge." This fee is charged to recoup expenses incurred

(a) as interest paid on financing physical inventory;
(b) as storage charges on physical inventory;
(c) as insurance costs on physical inventory;
(d) commissions on future contracts;
(e) contango expense.

IPMC bases the leverage fee on the client's unpaid daily balance. The fees are billed quarterly, currently at an annual rate of 9⅞ percent.

The question often raised is the following—"if the leverage merchant does not hold an inventory of the commodity being merchandised how can he validy charge a fee which is claimed to be a 'carrying charge'? Is this not a fictitious charge?"

Of course this question would not arise if the leverage transaction merchant (LTM) did in fact hold physical inventory to cover the full extent of his leverage sales. In that case he would incur out-of-pocket expenses such as interest, storage costs, and insurance which would in the normal course of events be passed on to his clients.

At the other extreme it is possible to visualize the case of a LTM who holds no inventories of the commodity in question and who does not cover his client position in any way. In this case no carrying charge would be justified. However, the merchant in this situation would be an outright speculator with a (presumably large) net short position. His net worth is reduced by any increase in prices. In this case the client is simply betting against the LTM. It is highly likely that such a merchant would remain in business for a short time only and the leverage contracts sold by him to the public would be of very dubious value as an investment medium. In fact, however, this is not the way in which the leverage firm studied in this paper carries out its business.

Although only a relatively small proportion (generally 15–25 percent) of the firm's client position is covered by inventory of the commodity itself, the firm has a very strict policy of covering the remainder of its short position with purchases of future contracts. This hedged position must of course be "rolled over" from time to time as futures contracts are not traded as far into the future as the term of the leverage contract. This rolling over will normally be undertaken with a view to profiting from movements in inter-temporal price spreads but the underlying purpose of the futures position is clear and simple. By being fully hedged in cash and futures the LTM is essentially reducing his exposure to price fluctuation and hence ensuring his own financial integrity and thereby the integrity of the leverage contract itself. This important role of the LTM's hedging operation cannot be understated.

The question remains however as to what justification exists for LTM to levy a carrying charge for that portion of the client position which is covered in futures rather than actuals. The answer lies in the fact that in addition to brokerage fees incurred in futures operations the LTM incurs the expense arising from increases in spot prices relative to futures prices. The phenomenon, which is pervasive in gold and silver futures markets, is reflected in the array of futures prices in which spot-prices are lower than nearby futures prices which in turn are lower than distant futures prices. In such a market structure it is inevitable that purchase of futures against cash or spot sales will result in a loss.

The extent of this loss (equivalent to the price spread between cash and futures prices) is predictable, because the price spread itself is determined by a basic economic law known as the "theory of the price of storage." This law, first discovered in the context of grain futures markets, has been found to be applicable to futures markets in all commodities for which continuous inventories are held.[7] In essence it states that the price spread between cash and futures prices (or between futures prices of contracts maturing at different dates) is a market determined price of storage. In the grains the major determinants of this price of storage are inventory costs and interest rates. In gold and silver interest rates dominate as the explicit storage costs and convenience yield of holding stocks are relatively minor.

This point is worth underlining because it demonstrates that these price spreads, and consequently losses incurred by LTM on its hedging operations, are not determined in an arbitrary fashion but rather are the outcome of a well-functioning market mechanism. Finally, to further illustrate this we have carried out a simple statistical analysis using data relating to the IMM gold bullion contract. Using 124 weekly observations the price spread (expressed as a percentage) between the two most nearby futures contracts was regressed against the appropriate interest rate, in this case the yield on 90-day Treasury Bills. The results are as follows:

$$\begin{aligned} SPR = -0.04188 + {} & 0.01331\ IR \\ & (0.00106) \end{aligned}$$

This equation accounts for 60% of the variation in the percentage price spread but considerably more (approximately 85%) of the variation in the flat price spread. This demonstrates clearly how price spreads (and contango expenses) in these markets are determined by exogenous economic forces.

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[7] H. Working, "Theory of the Inverse Carrying Charge in Futures Markets," Journal of Farm Economics, 30 (1948) pp. 1-28, and "The Theory of Price of Storage," American Economic Review, December 1949, pp. 1254-1262 (both reprinted in Selected Writings of Holbrook Working, Chicago Board of Trade (1977)). See also M.J. Brennan, "The Supply of Storage," American Economic Review, March 1958, pp. 50-72.

4. THE PRICING MECHANISM

Economists have long recognized the peculiar properties of prices determined in markets characterized by "perfect competition." These markets involve a large number of buyers and sellers, trading a homogeneous commodity, who have full information about all relevant market factors and who buy and sell freely amongst themselves. Very few "real world" markets approach this norm, with security markets and commodity futures markets probably doing so most closely.

The classic study of price behavior over time in these markets was carried out in 1949 by Holbrook Working[8] who argues that the extent to which market price promptly reflects all relevant information about commodity supply and demand can be measured by the randomness of price movements.

"From our models we can also deduce something about the nature of the price fluctuations it will generate. The able and well-informed traders whom we have been considering make their profits by getting information that permits them to predict price changes. The information on which these predictions are made, however, so far as it is new and useful for price prediction, it is itself unpredictable or nearly so. Consequently we may say, subject to slight qualification, that the price changes generated by the model are unpredictable price changes. That is, no change is predictable on the basis of the information that gives rise to the change. But this statement must be qualified because an important piece of new information must ordinarily generate a somewhat gradual price change, not an instantaneous one."[9]

Working's intuitive analysis was formalized by Professor Samuelson[10] and a large body of empirical analysis has since established that futures prices conform remarkably closely to this theoretical model.[11] For the most part those departures from randomness which have been found are consistent with the operations of scalpers who essentially perform a market-making function.

At first blush the environment in which leverage contract prices are determined appear to run counter to the world of perfect competition in almost every respect. While there may be many buyers there are relatively few sellers. Buyers are typically small investors and hence may not have access to all relevant information and may lack the means to evaluate effectively the information which they do have. Prices are not determined by open outcry but rather by the leverage merchant (LTM). This scenario raises the possibility that prices may be set in an arbitrary fashion to the benefit only of the LTM.

In order to evaluate this criticism we studied both the pricing policy and practice of IPMC, a major merchant of leverage contracts in gold and silver bullion coins. The firm's bullion prices are determined in the following way.

(a) The basic price indicator is taken from the price of the dominant future traded on the Commodity Exchange of New York.

(b) This futures price is factored to a spot price equivalent. This is done in accordance with recognized economic principles, the details of which were discussed above in Section 3.

(c) The spot price so obtained is quoted as IPMC's "bid" price, the price at which they will buy back leverage contracts from clients.

(d) The IPMC "asked" price, the price at which the firm will sell leverage contracts, is calculated as the "bid" price plus 5½ percent.

To the extent that this pricing policy is strictly followed many of the criticisms mentioned above are effectively rebuffed. Changes in futures prices, which are generally appropriate and prompt responses to new market information, are immediately translated into prices for leverage contracts. The 5½ percent differential between bid and asked prices is a return to the merchant for his overhead and similar costs and is essentially a retail markup. In the case of leverage contracts in coins the IPMC "bid" price is equal to the current spot quotation from a leading coin dealer. Again, the asked price is calculated as the bid price plus 5½ percent.

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[8] H. Working, "A Theory of Anticipatory Prices," American Economic Review, May 1958, pp. 188-199, reprinted in Selected Writings of Holbrook Working, Chicago Board of Trade, 1977.

[9] Ibid., p. 39.

[10] P.A. Samuelson, "Proof that Properly Anticipated Prices Fluctuate Randomly," Industrial Management Review, 6, Spring 1965, pp. 41-49.

[11] For example, A.B. Larson, "Measurement of a Random Process in Futures Prices," Food Research Institute Studies I, November 1960, pp. 313-324; C.S. Brinegar, "A Statistical Analysis of Speculative Price Behavior," Food Research Institute Studies, IX, 1970, Supplement; R.A. Stevenson and R.M. Bear, "Commodity Futures Prices: Trends or Random Walks," Journal of Finance, 25, 1970, pp. 65-81. Somewhat different results are reported by J.S. Mann and R.G. Heifner, "The Distribution of Shortrun Commodity Price Movements," U.S. Department of Agriculture, ERS Technical Bulletin 1536, March 1976, who find a significant tendency to continuity in price. These results are most likely due to their use of individual contracts as the unit of analysis.

In order to provide some degree of independent verification that the above pricing mechanism is in fact generally followed, a sample of 179 leverage transaction prices (112 in sliver and 67 in gold) was taken and these prices compared with spot gold and silver bullion prices quoted in New York by Handy and Harman. The Handy and Harman prices are widely accepted as authoritative indicators of spot bullion values and were taken from the yearbooks of the International Monetary Market Division of the Chicago Merchantile Exchange. Specifically the following simple regression equations were estimated

$$\begin{array}{lllll} L_G = & 1.2058 & + \ 1.0518 & H_G & , R^2 = 0.9979 \\ & (1.1602) & (0.005663) & & \\ L_S = & 12.3638 & + \ 1.0224 & H_S & , R^2 = 0.9501 \\ & (9.3783) & (0.02117) & & \end{array}$$

where

L_G, L_S are IPMC asked prices for gold and silver respectively,

H_G, H_S are Handy and Harman spot prices for gold and silver respectively. Figures in brackets are estimates of standard errors.

These results are consistent with the pricing policy described above. The correlation is not perfect because the Handy and Harman price is essentially a "closing" price whereas the transaction might have taken place at any time during the day.

In summary the pricing procedure and the empirical results support the view that leverage contract prices for bullion are a reflection of true market prices and are not determined in an arbitrary or discriminatory fashion. Of course this conclusion refers only to IPMC and is valid for the industry as a whole only to the extent that comparable policies are followed by other firms.

5. CUSTOMER TRADING RESULTS

Yet another approach to evaluating the leverage contract as an investment medium is to study the actual trading results of clients. Additionally, it may be of interest to examine the fee structure inherent in the leverage contract and thereby to compute the extent of price movement required to produce a profit.

We estimate that a price increase of approximately 17.3 percent in the first year and 8.1 percent in each subsequent year is required for the purchaser of a leverage futures contract to break even.[12] Of course if a contract is held for two or more years it is not necessary that these figures be achieved in each year, but that an equivalent accumulative rate of price increase occur (an average of 12 percent per annum over two years or 10 percent per annum over three years, for example). These figures are based on the following calculations.

1. Charges incurred on purchase

(i) IPMC asked price = 105.5 percent of bid price.
i.e. = 105.5 percent of current spot price.

(ii) At time of sale IPMC charges 3½ percent commission on total sale (no "exit commission" is charged when a contract is closed).

(iii) Therefore total markup "at front" = 9.2 percent.

2. Charges incurred on continuing basis

(i) Leverage fee of 9.875 percent on unpaid balance. Assuming an average unpaid balance of 75 percent,[13] the leverage fee represents an annual charge of 7.4 percent of the value of the commodity.

(ii) An annual service fee of 1 percent of the market value of the commodity is charged.

(iii) Therefore annual charges in addition to initial charges equal 8.4 percent. Tables 4 and 5 show the movement in gold and silver prices in recent years.

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[12] These figures are based on the rate structure used by IPMC.

[13] Unpaid balances represented 74.2% and 76.5% of liability to customers for metals valued at quoted market prices as of December 31, 1977 and 1976 respectively. These figures were obtained from IPMC Notes to Financial Statements for year ended December 31, 1977 and 1976 (p. 10).

TABLE 4.—MONTHLY AVERAGE SPOT PRICE OF SILVER BULLION, NEW YORK

[Cents per ounce[1]]

	1973	1974	1975	1976	1977	1978
January	201.7	363.7	419.3	406.3	440.9	493.7
February	223.6	535.9	437.0	408.6	452.7	494.8
March	230.9	532.6	434.5	418.9	483.9	523.4
April	220.7	503.6	420.9	435.1	478.3	511.9
May	240.1	543.2	453.8	448.9	469.2	590.7
June	262.1	489.6	448.9	481.2	444.2	
July	270.6	441.6	470.5	478.0	449.8	
August	263.7	443.1	492.5	423.7	443.9	
September	267.5	404.9	451.6	429.5	453.9	
October	288.6	483.0	432.9	442.5	475.7	
November	286.0	469.4	433.2	437.2	483.1	
December	313.7	439.1	408.5	434.7	470.4	
Price increase during year (percent)	+55.5	+20.7	−2.6	+7.0	+6.7	[2] +3.2
Maximum price increase from low to subsequent high (percent)	+55.5	+49.4	+17.5	+18.4	+9.8	[2] +6.0

[1] Source January 1973–February 1977, 1977 Commodity Yearbook, March 1977–May 1978, Wall Street Journal.

[2] Refers to January–May only.

TABLE 5.—MONTHLY AVERAGE SPOT PRICE, GOLD BULLION, NEW YORK

[Per ounce[1]]

	1975	1976	1977	1978
January	$176.8	$132.0	$132.9	$173.8
February	180.0	131.6	136.4	178.7
March	178.6	133.1	148.7	183.2
April	170.3	128.4	149.8	1755
May	167.9	127.4	147.2	175.6
June	164.7	126.4	141.6	
July	165.7	118.0	144.0	
August	163.5	110.1	145.5	
September	144.1	114.7	150.6	
October	143.3	116.6	159.2	
November	143.3	131.4	162.9	
December	139.8	134.4	161.1	
Price increase during year (percent)	−20.9	+1.8	+21.2	[2] +1.0
Maximum price increase from low to subsequent high (percent)	+1.8	+22.0	+22.6	[2] +5.4

[1] Source, January 1975–January 1977, 1977 Commodity Yearbook; February 1977–May 1978, Wall Street Journal.

[2] Refers to January–May only.

The figures in these tables are monthly average prices, hence the extent of daily price variation (and potential trading profits) is significantly understated. Yet even from these figures it can be seen that price variability is such that purchases of leverage contracts can be profitable given good judgement of future price movements.

Having established that it is feasible for a customer to profit from leverage contract transactions we turn our attention to the extent to which such transactions have in practice resulted in profits. Early in 1978, as part of an industry wide CFTC survey into "retail leverage-type transactions," the Commission's Division of Enforcement collected data on more than 700 individual accounts held by clients of IPMC. For purposes of analysis we discarded approximately 80 accounts involving transactions in copper, as IPMC no longer offers leverage contracts in copper, leaving 619 accounts. Of these 189 accounts were active as at the survey date (March 8, 1978) and 430 were closed accounts.

In order to compute the profitability of these accounts all relevant fees were levied against active accounts. When this was done 32.5 percent of all accounts were profitable, while 67.2 percent resulted in a loss. A significant difference was found between active accounts and those which had been closed. 61.9 percent of active accounts were profitable while only 19.5 percent of closed accounts showed a gain. Full details are shown in Table 6.

TABLE 6.—SUMMARY OF IPMC PROFIT/LOSS SURVEY

Commodity	Profit accounts	Loss accounts	Total
Gold bullion	36	63	99
Silver bullion	85	287	372
Krugerrands	59	35	94
Sovereigns	13	18	31
Clads	3	11	14
Double Eagles	5	1	6
90 percent silver		2	2
Mexican 50 pesos		1	1
Total	201	418	619

This analysis suggests that purchasing a leverage contract is generally a poor investment. However it is important to realize that the above results are quite consistent with studies of the results of commodity investments by small traders generally and are not peculiar to investment in leverage contracts.

So far as we can determine three studies of distribution of profits based on recorded trading results have appeared in the literature. The earliest of these was undertaken by Stewart [14] who analyzed the complete trading records of 8,922 customers of a large Chicago commission firm over the nine-year period 1924–32. He found that only 2,184 (24.5 percent) of the customers' accounts yielded a profit. A more detailed analysis by comodity is provided in Table 7. In discussing these results some years ago the present authors [15] noted: This dismal record is ameliorated by two major considerations; (1) the commission firm went bankrupt, suggesting that traders dealing through other commission firms may have had better success, and (2) the period was one of net price decline, and a disproportionate share of the losses were incurred during the last 3 years, when prices declined sharply, whereas the sample of traders was mainly on the long side. It is perhaps too much to expect avocational comodity speculators to forecast a severe slump in general economic conditions. It is unfortunate, to say the least, that this is the only published *record* of trading results for any substantial group of traders over any extended time period.

TABLE 7.—SUMMARY OF RESULTS OF STEWART STUDY [1]

	Profit traders			Loss traders		
Commodity	Number	Total net profits	Average profit per trader	Number	Total net losses	Average loss per trader
Wheat	2,045	$1,508,407	$738	5,496	$9,411,620	$1,712
Corn	1,525	1,183,993	776	2,403	2,222,602	925
Oats	589	124,038	211	997	772,132	774
Rye	497	293,042	590	816	825,838	1,012
All grains [2]	2,184	2,064,800	945	6,598	11,958,200	1,812

[1] Blair Stewart, "An Analysis of Speculative Trading and Grain Futures", p. 57.

[2] The "all grains" figures are not equal to the totals of the figures for individual grains because some traders made profits in one or more grains but lost on their futures transactions in one or more of the other grains.

In the period since that was written two studies of commodity trading records have appeared. The first of these is reported in Professor T.A. Hieronymus' well known textbook [16] and is based on records of closed trades for a commission house for the calendar year 1969. The results are reported in detail in Table 8, but their most salient feature is that 35 percent of the firm's customers recorded a profit (and 65 percent recorded a loss). Commodity prices in 1969 fluctuated moderately without exhibiting any marked trend.

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[14] Blair Stewart, "An Analysis of Speculative Trading in Grain Futures", Washington, D.C., U.S.D.A. Technical Bulletin No. 1001, October 1949.

[15] Roger W. Gray and David J.S. Rutledge, "The Economics of Commodity Futures Markets: A Survey." Review of Marketing and Agriculture Economics, Vol. 39, No. 4, December 1971 (Sydney, NSW, Australia), p. 24.

[16] T.A. Hieronymus Economics of Futures Trading," Commodity Research Bureau Inc., New York, 1971.

Even more recent is a study by R.L. Ross,[17] in which a cohort of customer accounts established in 1967 and 1968 was followed over a five-year period. The results are summarized in Table 9, but again the major finding is clear—of 380 traders covered in the survey 242, or 63.7 percent, recorded losses. Over the period covered by the Ross study commodity priced fluctuated considerably but without any obvious trend in aggregate.

TABLE 8.—*Summary of results of Hieronymus study* [1]

Number of accounts	462
Number of accounts with profits	164
Total profits (dollars)	$462,413
Profit per account	$2,819
Number of accounts with losses	298
Total losses	$1,127,355
Losses per account	$3,783
Average result (loss)	$1,439
Net loss, all accounts	$664,942
Commissions paid	$406,344
Put to clearing house	$258,598

[1] Thomas A. Hieronymus, Economics of Futures Trading, Commodity Research Bureau, New York, 1971, p. 253.

TABLE 9.—SUMMARY OF RESULTS OF ROSS STUDY [1]

Years of trading	Profitmakers			Losers			
	Number	Total	Average profit	Number	Total	Average loss	Net loss of all traders
One	70	$40,153	$574	124	$252,135	$2,033	$211,982
Two	35	49,161	1,405	80	473,363	5,917	424,202
Three	19	147,693	7,772	24	163,768	6,828	16,075
Four	13	317,041	24,388	13	328,678	25,283	11,637
Five	1	2,399	2,399	1	9,381	9,381	6,982
Total	138	556,447		242	1,227,325		670,878
Average			4,032			5,030	

[1] Ray L. Ross, "Financial Consequences of Trading Commodity Futures Contracts," Illinois Agricultural Economics, July 1975, Table 4, p. 30.

The studies reported by Hieronymus and Ross suggest that the tendency for small speculators to lose money is perhaps more pervasive than we believed in 1970.

Nevertheless the analysis does show that the trading results obtained by leverage customers of IPMC do not appear to differ significantly from those of small traders in commodities generally. There is no evidence of any interest characteristic in the leverage contract which preordains an unusual tendency towards trading losses.

If this is so, the trading losses must be attributed to errors of judgment on the part of individual traders. That this is indeed the case is strongly suggested by the following additional analysis of the IPMC survey accounts. Suppose that the 430 accounts which were closed prior to March 8, 1978 had not been closed, but had been held open until March 8. After all leverage and service costs have been accounted for, 229 (53.3 percent) of these accounts would have shown a profit. Many unprofitable accounts would have earned profits had they not been closed.

Further evidence, if it is required, of the difficulties facing the small trader in forecasting commodity prices is provided in a study by Rockwell.[18] Rockwell's analysis involved computing hypothetical trading results for highly aggregated classes of futures traders, among them "small traders" who are probably mainly speculators. His results show small traders approximately breaking even, but more important for present purposes, the analysis shows that these traders exhibit no ability as a group to forecast commodity prices.

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[17] Ray L. Ross, "Financial Consequences of Trading Commodity Futures Contracts," Illinois Agricultural Economics, July 1975, pp. 27–31.

[18] Charles S. Rockwell, "Normal Backwardation, Forecasting, and the Returns to Commodity Futures Traders," Food Research Institute Studies, VII, Supplement, 1967, reprinted in A.E. Peck, ed., Selected Writings on Futures Markets, II, Chicago Board of Trade, 1977.

Another perspective on trading results is gained by comparing investment in gold and silver via a leverage contract with returns which would have been earned in alternative investments. We have already noted the tendency for prices of precious metals to move counter-cyclically with the stock market. Over the period covered by Tables 4 and 5 the stock market has not performed well from the point of view of the small investor. This fact assumes added significance in light of the trading results of those IPMC accounts which remained open at the time of the CFTC survey. It is amongst these accounts that we would most expect to find individuals trading in precious metals as a long term hedge against inflation and it is precisely these accounts which have recorded the best results.

By way of conclusion we would argue that analysis of trading results, while of considerable interest, cannot be used to infer that there is an inherent bias towards losses in the leverage contract. Provided that the customer is given full information about the rate structure (as IPMC's customers are), and hence can calculate the price increase required to produce a profit, we are of the opinion that no such bias exists. When prices rise persistently holders of leverage contracts will make profits and one must assume that purchase of the contract was predicated on the expectation of such a price rise. If the expected price movement does not occur the holder of the contract will incur a loss, but this loss is a reflection of an incorrect judgment as to price.

6. HEDGING POLICY AND PRACTICE

The Subcommittee on Futures, Forward and Leverage Contracts of the CFTC Advisory Committee on Market Instruments included in its deliberations a study of the question of coverage of leverage transactions. On this subject it recommended as follows:

"There must be 100% coverage of all Section 217 transactions. Permissible coverage may be a Commission determined combination of futures, forwards and actuals. This should be qualified, however, by the following rules:

(A) A gold obligation cannot be covered in silver and vice versa;

(B) A bullion obligation can be covered in bullion and/or coin (with appropriate regard for the bullion content of the coin); and

(C) A coin obligation can be covered in coin but not in bullion." [19]

The basis for this recommendation is that if the LTM is permitted to sell "naked" leverage contracts there can be no guarantee that he will be able to fulfill his obligations in the event that the customer makes all required payments and demands delivery. Moreover, as we have noted earlier, the LTM who holds little or no cover is highly vulnerable to adverse price movements and consequently is likely to fail, causing losses to all his clients with open positions. There can be little doubt that many of the difficulties associated with the commodity options industry arise from the practices of selling "naked" options.

On the basis of information supplied to us by IPMC we are satisfied that its hedging policy is consistent with the spirit of the Advisory Committee's recommendations. Figures included in the Notes to IPMC's Finanical Statements (audited by Coopers and Lybrand) show that long positions in futures, forwards and actuals as at December 31, 1975 and December 31, 1977 were more than sufficient to cover quantities due to customers in all commodities.

We have also examined IPMC's hedge position in gold and silver bullion at monthly intervals from September 1975 to April 1978. In the case of these commodities coverage is held exclusively in futures and actuals, thereby meeting the concern of three members of the Subcommittee who believed that forward contracts should not be a form of permissible coverage. In general coverage via futures contracts accounted for approximately 75 to 85 percent of total long position held by IPMC in gold and silver bullion, with the remainder being physical inventory. As far as we can judge, such variation in these proportions as has occurred over time has been consistent with normal business practice involving the management of spot and futures positions.

In the case of bulk coins, where active futures markets are not available, IPMC's hedge position is held jointly in actuals and forward cash commitments.

We note in conclusion that the abilty of the LTM to fulfill his delivery obligations is assured only by coverage in actuals. Experience to date suggests that less than ten percent of leverage contracts are closed out by delivery [20] so that this is unlikely to be a problem in practice. On the other hand, coverage in futures and forward contracts generally provides adequate cover against adverse price movement.

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[19] CFTC Advisory Committee on Market Instruments, "Recommendations of Subcommittee on Futures, Forward and Leverage Contracts," pp.11-12. Three members of the Subcommittee dissented from the recommendation that forward contracts should be a form of permissible coverage.

7. COMPLIANCE AND RELATED ISSUES

As noted earlier in this study, and CFTC, although empowered to do so, had not taken steps to regulate leverage transactions in gold and silver. Nevertheless it is possible to compare present industry procedures with the regulatory framework recommended by the CFTC Advisory Committee. In addition to those discussed elsewhere in this study, the important features of these recommendations, designed to ensure an acceptable degree of customer protection, were as follows:

(a) Registration of LTM's;
(b) Minimum financial requirements of LTM's;
(c) Segregation of customer funds;
(d) Establishment of requirements for advertising and promotional material;
(e) Requirements with respect to financial reporting;
(f) Disclosure requirements;
(g) Know-your-customer rules.

We have studied the financial reports and the operations of the Compliance and Customer Relations Division of IPMC and are of the opinion that they conform with the spirit of the proposed regulations.

A very crude, but nevertheless interesting, measure of the extent of this conformity is obtained by examining IPMC's records concerning customer inquiries and complaints. In the period 1975-1977 (inclusive) a total of 52 inquiries or complaints were received by IPMC, state authorities or the CFTC. Of these 42 were resolved by mutual agreement between the customer and IPMC, withdrawn by the customer, or answered by IPMC with no further action taken. Only 7 cases involved litigation or formal docketing as a complaint in a CFTC reparations proceeding. Further details are provided in Table 10.

TABLE 10.—SUMMARY OF IPMC LEVERAGE CUSTOMER INQUIRIES/COMPLAINTS DURING 1975–77

Year	Number of inquiries/complaints	Action by Customers	Resolution
1975	2	Inquries to IPMC	Resolved in-house.[1]
	1	CFTC reparations complaint	Settled.
1976	15	Inquries to IPMC	Resolved in-house.[1]
	1	Inquiry to IPMC	Withdrawn by customer
	1	Inquiry to IPMC and state authorities	Withdrawn by customer
	2	Inquiries to IPMC and state authorities	Inquiries answered, no further action by state authorities.
	2	Inquiries to CFTC, referred to IPMC	Inquiries answered, no further action by CFTC.
	1	Action filed in state court	Settled.
	1	CFTC reparations complaint	Settled.

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[20] CFTC, Press Release, April 27, 1978, p. 2.

TABLE 10.—SUMMARY OF IPMC LEVERAGE CUSTOMER INQUIRIES/COMPLAINTS DURING 1975–77—Continued

Year	Number of inquiries/complaints	Action by Customers	Resolution
1977	14	Inquiries to IPMC	Resolved in-house [1]
	5	Inquiries to IPMC	Withdrawn by customer.
	1	Inquiry to IPMC	Resolution pending.
	1	Inquiry to state authority, referred to IPMC	Inquiry answered, no further action by state authorities.
	1	Inquiry to state authority, referred to IPMC	Settled.
	1	Inquiry to CFTC, referred to IPMC	Settled.
	1	CFTC reparations complaint	Dismissed by CFTC—Division of Enforcement.
	1	CFTC reparations complaint	Settled.
	1	CFTC reparations complaint	Pending (as of May 26, 1978).

[1] Note The term "resolved in-house" refers to inquiries resolved through either (a) an explanation to the customers' satisfaction, after which the complaint was withdrawn or no futher action taken by the customer, or (b) a mutually agreeable monetary settlement between IPMC and the customer.

While these figures are of some general interest it is impossible to draw any definitive conclusion from them and we do not intend to do so. However, they do allow us to suggest, with caution, that the extent of customer dissatisfaction with IPMC's leverage operations is not great and not disproportionate when compared to other similar industries such as the futures industry. Some support for this view can be derived from the fact that the CFTC Annual Report for 1977 makes no mention of complaints or litigation relating to leverage contracts. This is all the more surprising in light of the regulatory vacuum within which the industry is presently operating. Presumably the extent of customer dissatisfaction would diminish following the introduction of a satisfactory set of regulations.

8. DEFINITIONAL ISSUES

The foregoing sections of this study have described and analyzed the leverage contract, particularly as it is written and marketed by IPMC. This has necessarily entailed some comparisons to other instruments or investments, but it has not adduced the full extent to which leverage contracts have been confused with some alternatives in the regulatory environment. In this section we propose to address this confusion, with special reference to the question whether a leverage contract may be said to be a futures contract.

There exists no statutory definition of a leverage contract, nor for that matter of a futures contract, nor are such definitions proposed here. Instead we proposed to address the issue as one of clear distinctions which must be made and held. There are inumerable instances in commodity law in which terms that are employed are not explicitly and categorically defined, but where instead reference must be had to "commonly understood" meanings arising out of business practice and case law determinations. One reason for this is that any effort to define such terms rigorously and exhaustively would soon invite slight variants in practice which could provide exclusions; whereas on the other hand broader definitions may be inclusive of fundamental differences among concepts.

The advisory task force on market instruments undertook to characterize leverage and other commodity contracts according to an extensive list of descriptive elements, thereby providing a useful taxonomy, but failing at the same time to focus upon the economic role or function of each particular instrument. The CFTC has subsequently become so preoccupied with the options problem that it has been tempted to play with definitions in order to avert the recurrence of that problem in whatever form. Having been empowered to ban the sale of commodity options, but not leverage contracts, and having proceeded to invoke its powers against certain forms of options trading which it found fraudulent or abusive, the CFTC has now perceived that some firms that are proscribed from selling options are entering the leverage contract business. Their frustrations and apprehensions are understandable. The options trading which led to the original (1936) ban against trading options in defined "commodities" was of a markedly different character from the options trading which led to the debacle of the early 1970s. The former comprised chiefly "overnight" puts and calls and was engaged in mainly by commercials and professionals. The latter (a la Goldstein-Samuelson) entailed the retail sale to the public of options on non-regulated commodities (not defined in the 1936 act as amended prior to 1974). Clearly the Goldstein-Samuelson fiasco was the outgrowth of a loophole (unregulated commodities); but no sooner was that loophole plugged than another (London options) was revealed, and soon exploited. Moreover, the two experiences of the 1970s revealed two opposite extremes at which options may be said to be "inherently fraudulent" (1) the options may be priced so cheaply that there is no reasonable probability that the options writer can pay off—hence a Ponzi scheme, or (2) the options may be priced so dearly that there is no reasonable prospect that the customer can make money. In between these extremes, and short of "inherent fraud," lie a range of possibilities for misrepresentation, "boiler room" sales tactics, and the like. That the CFCT should seek to assure competitive pricing by confining options trading to exchanges in these circumstances is not surprising, notwithstanding the fact that a limited exemption has already been posted to this neat solution.

By extension of their options experience, the CFTC might have been expected at this point to argue that a leverage contract is not significantly different from an option contract, especially as both are marketed at retail at prices established by the seller (which similarities have not passed unnoticed by firms formerly marketing London options). This argument would have to confront the stautory distinction, however, as well as some obvious mechanical distinctions. This easy choice was denied CFTC by virture of the fact that they were empowered to ban options trading directly, if they chose, but if they were to effectively prohibit leverage transactions it would have to be by indirection.

Two indirect avenues which they have explored, and which would effectively ban leverage contracts as presently marketed, are (1) yielding up leverage contract regulation to the SEC, or to state agencies, by implicitly defining them to be securities, and (2) defining leverage contracts to be futures contracts. The first of these proposals to "define away the problem" can be disposed of quite briefly; the second and presumably more viable alternative (in CFTC's view) needs more careful consideration.

Defining leverage contracts to be securities

The CFTC has been understandably defensive of its jurisdiction over futures trading in securities, such as GNMA mortgage backed securities and treasury bills. This posture provides a backdrop against which any suggestions that SEC should regulate leverage contracts appears bizarre. Competent authorities may disagree as to whether a futures contract in a security is itself a security (we think it is not); but there is not disagreement so far as we know that a commodity contract is not a security.[21] The courts have so held consistently, and in particular as to leverage contracts. Thus for CFTC to abdicate its regulatory role over leverage contracts in favor of SEC really implies one of two outcomes: (1) SEC would correctly construe it that these are not securities, and leave them unregulated, or (2) SEC would incorrectly construe it that they are securities, invoke regulation "T" margin requirements, and put existing firms out of business. The first outcome is inconsistent with CFTC fears that there may be serious real or potential problems in the leverage industry. The second outcome is to accomplish by twisting words what they are reluctant to do by twisting the sword.

Defining leverage contracts to be futures contracts

More recently the CFTC appears to have been leaning, not to say straining, toward the interpretation that a leverage contract is, in all but name or unimportant particular, really a futures contract after all. This line of semantics carries the interesting implication that, since the leading "unimportant particular" in which leverage and futures contracts differ is that the latter are traded on organized exchanges with clearing mechanisms, leverage contracts should be required to be so traded. Given the existence of very active futures markets for gold and silver, existing leverage transactions would simply disappear under this requirement, thereby proving that they never really existed.

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[21] See, for example, A. Bromberg "Commodities Law and Securites Law—Overlaps and Preemptions," The Journal of Corporation Law, 1, 2 (1976) p. 234.

The acting chief economist of the CFTC, in his memorandum to the commission dated May 8, 1968, has concluded that most leverage contracts are "essentially futures contracts." The major difference between leverage and futures contracts—the fact that leverage contracts are retail extensions of futures contracts and are priced and sold differently (off exchanges)—is brushed aside as an irrelevancy. "Once it is granted that the off-exchange nature of leverage contracts is not germane to the determination of whether or not they are futures contracts" it is asserted (p. 4), "many of the 'distinguishing characteristics' become irrelevant." As with many a syllogism, the trick is to slip the major premise through. But it cannot be "granted that the off-exchange nature of leverage contracts is not germane . . ." Leverage contracts are designed for, and evidently appeal to, a different clientele from those who trade futures. In particular, they are predominantly longer term contracts and they are marketed in smaller units. The memorandum from the acting chief economist to the CFTC attempts, without success, to belittle these distinctions. By citing sample evidence that contracts of nominal five or ten year duration are held open on average for less than a year, the chief economist would have us believe that this is comparable to futures. We are not provided, however, with any evidence regarding the average holding period of small futures speculations, which would almost certainly be less than a month. As a matter of fact, IPMC contracts has had an average duration of just under a year for closed contracts, whereas those remaining open had been open for a year on average. Secondly, we are told that futures exchanges attempt to curry public favor by promulgating smaller contracts than the commercial trade might prefer, and that the Midamerica Commodity Exchange actually specializes in smaller futures contracts. But we are not given the additional facts that leverage contracts are smaller still, and that most customers purchase only one contract. Nor are we told that fractional leverage contracts are available to the customers who already have one contract. In short, while leverage contracts are extensions of futures in two dimensions that futures exchanges have not seen fit to match, this aspect is glossed over in the memorandum by the acting chief economist. One dimension is the size of contract, which is significantly smaller—the other is duration, which is significantly longer.

To consign this distinct market to the futures exchanges would not only have the effect of putting reputable firms out of business, but would probably have the effect of consigning this distinct market to oblivion. Futures exchanges have displayed no interest in contracts of this size or duration. When the Comex, for example, went twenty-three months out with its silver futures contract, it was done to accommodate certain sophisticated tax-spreads—not at all in order to reach the small investor. The basic reason why futures exchanges do not promulgate long term or retail size contracts is that they do not perceive sufficiently large trading volume to justify them—and the prospect of very thin trading in such contracts poses two related problems: (1) prices become less reliable and trading costs rise; and (2) CFTC might well revoke designation of such contracts. In effect, this could bring matters full circle. The CFTC, by forcing this market onto futures exchanges, could find either that exchanges don't want it or that they would be unable to service it to CFTC satisfaction.

Further in regard to contract duration, the memorandum to the CFTC ignores the point that contracts written for distant delivery dates must be priced as though they are to be held to such date, irrespective of whether many are offset earlier. In the case of futures contracts, for raw materials commodities, the low liquidity and greater risk attaching to distant months typically means that the seller must accept a discount. The reason for this has been that hedge sales have predominated over hedge purchases, and speculators have been willing to buy distant futures only at discounts. Gold and silver, however, are commodities reflecting a store of value, and to the extent that there is any great hedging interest in them it is as a hedge against inflation. This means that such "hedgers" are buyers, and hence that speculators who would contract with them need to be sellers, hence that more distant futures must be priced at a premium. A similar phenomenon is reflected in the normal term structure of interest rates. "Liquidity preference" is for money over goods in the short term—but for many people in an inflationary environment it is distinctly for gold or silver over money in the longer term. Thus a contract which calls for the exchange of gold or silver for money five or ten years in the future must relate to long term interest rates and entail higher carrying costs than a nearby futures contract. The buyer of a leverage contract has the alternative (if he wishes to deal in sufficiently large quantities) of owning nearby futures and rolling these forward as long as he wants to hold. What would he save owing to smaller contangos and greater liquidity in nearby futures he would probably give back in commissions on a series of transactions.

As an example, on May 31, 1978, the nearby June-September spread in silver futures on the Chicago Board of Trade was under eight cents per ounce whereas the 1979 June-September spread was 10½ cents per ounce (settling prices). This difference reflects the larger contango on distant futures; but it does not reflect the possible higher cost of obtaining a purchase a year out.

In light of the above considerations it is our conclusion that leverage contracts provide a distinctive retail package which is not available on the futures exchanges. Leverage contract dealers can manage a hedging program with greater expertise and at lower costs as compared to their customers, and as with any retail operation customer convenience would be expected to entail a price. The "retail mark-up" would include reasonable sales commissions, service charges, and of course the carrying charges (inventory costs) incurred by the retailer. Obviously in the absence of competition or sufficient customer information, such a retail mark-up could be exorbitant; but from our examination of the records and practices of IPMC we conclude that their leverage contracts are reasonably priced.

Other definitional escapes

If the CFTC chooses to play "blind men and elephant" as it gropes toward escaping its regulatory responsibilities, the aforementioned alternatives do not exhaust the possibilities. There are at least as many possibilities as there are commissioners. One can grasp the leverage contract where it most resembles an option contract, another can grasp it where it most resembles a security, another where it most resembles a futures contract—still another, if he so chose, could declare that IPMC is an exchange; leaving it to the last commissioner to assert that IPMC is a "bucket shop." (We offer these suggestions satirically in full view of the possibility that they might be taken seriously.)

But an elephant is neither a wall, nor a spear, nor a snake, nor a tree, nor a fan, nor a rope—nor really anything else than an elephant. A leverage contract is a leverage contract—clearly distinguishable from other forms of commodity trading or investment—and should be regulated accordingly.

9. CONCLUSIONS

The major conclusions of this study have already been stated in each section. Brought together they can be summarized as follows:

(a) The leverage contract in gold and silver is a potentially useful investment tool for the general public. At the same time it is a financial instrument which differs in several substantive respects from other forms of forward contracts such as the futures contract.

(b) The process of price determination followed by IPMC is not arbitrary. Rather leverage contract prices are tied to futures prices in a natural way so that all the positive attributes of futures prices are transmitted to leverage contract prices.

(c) The "leverage fee" or "carrying charge" expense incurred by purchasers of leverage contracts is not a fictitious fee but is based on sound economic and business principles.

(d) The trading results of leverage contract customers, based on a sample of IPMC accounts, are very similar to results obtained by small commodity traders in general. There appears to be no significant tendency for leverage account customers to incur trading losses when compared to other forms of commodity investment.

(e) The policies and practices of IPMC regarding coverage of client positions, segregation of customer accounts and compliance matters generally, are in accord with the regulatory framework for the industry which was recommended by the CFTC Advisory Committee on Market Instruments.

The Commodity Leverage Contract: An Economic Analysis Synopsis

This study presents an economic analysis of the leverage contract in gold and silver. It draws on the general body of literature in commodity economics, but also utilizes data made available by International Precious Metals Corporation (IPMC), a major firm in the leverage contract industry.

As a point of departure we consider the leverage contract as a possible investment tool for the general public, finding that its characteristics are such as to offer certain advantages to the small investor. Elsewhere in the study we consider the more broad-ranging issue of the nature of the leverage contract as an economic instrument. We conclude that the leverage contract differs substantively from other forms of forward contracts and, in particular, from the futures contract.

Turning next to the operational side of the industry, as represented by IPMC, we study the mechanism whereby leverage contract prices are determined finding that these prices behave essentially like competitively determined prices in an open anticipatory market.

We also examine the economic basis for the "leverage fee" or "carrying charge," a significant expense incurred by purchasers of leverage contracts. This fee has sometimes been called a "fictitious fee" and has been the subject of some criticism. However, we find that the carrying charge is a valid business expense incurred by firms in the industry and that it is determined, not in an arbitrary fashion, but by basic economic forces.

Next we consider the actual trading results of a sample of IPMC customers. Comparing these results with those of small investors in commodities generally we find a remarkable degree of conformity. As far as we can judge leverage contract customers are not more prone to losses than are small traders in commodity futures markets.

Finally we examine IPMC's operations regarding coverage of customers' positions, segregation of customer accounts and other compliance matters. We find that IPMC practice is in accord with the regulatory framework recommended in 1976 by the CFTC Advisory Committee on Market Instruments.

FEBRUARY 20 HEARING

STATEMENT OF HONORABLE MITCH McCONNELL
A U.S. SENATOR FROM KENTUCKY

Mr. Chairman, the reauthorization of the Commodity Futures Trading Commission is one of the more important activities of the Committee this year. It's important because it serves as the regulatory body for futures commission merchants. Although this hearing will again delve into issues of broader substance than trading agricultural commodities futures contracts, we must recognize that our farmers must be protected as they regularly begin to use options and futures as marketing tools. There are couple of important issues that merit consideration by this committee before we move this bill.

It is my opinion that leverage contracts must be eliminated. There is no reason that leverage contracts should be receiving preferential statutory treatment when, for all intents and purposes, these contracts are legally and economically indistinguishable from futures contracts. The law governing operation of the commodities markets mandates that futures contracts must be traded on government-approved exchanges; leverage contracts should be required to be traded in a similar manner. I'm concerned that if action is not taken to regulate leverage contracts that "over-the-counter" futures contracts could blossom into a widespread business which would be increasingly difficult to regulate effectively.

I'm sure Mr. Chairman, that you could see the problems inherent under that scenario. The CFTC would be unable to effectively regulate these transactions. Consumers would more easily be objects for fraudulent activities, because leverage prices are especially susceptible to artificial price fixing by leverage firms who are trying to generate income. The best solution to this leverage issue is to require that leverage contracts be subject to the same restrictions as futures contracts. In my judgement, that approach insures the continued integrity of the Commodity Exchanges as a viable marketing option.

There is also the issue of enforcement and litigation. This legislation introduced by Chairman Helms and sub-Committee Chairman Lugar does a decent job of protecting futures and options traders by clarifying what constitutes fraud in a futures transaction. In addition, greater regulatory power for the CFTC to subpoena witnesses in investigations of possible fraudulent activities will lead to more thorough job of uncovering irregularities within the industry. Finally, to protect the interests of investors in a liquidated brokerage firm, this legislation would give the Commission license to directly appoint a receiver to insure immediate protection of the firm's business records. This proposal would prevent delays which have plagued the CFTC in situations of this kind which have occurred in the past.

Again, Mr. Chairman, I anticipate that the Commodity Markets will play an increasing role in agricultural marketing as farmers improve their marketing habits. It is vitally important, inasmuch as is possible, that we protect the integrity of the institution from abuse. I applaud the efforts of the Commission in using all the tools at its disposal to develop audit trails which will make detection of abuse easier.

We owe that much to our country's struggling farmers.

STATEMENT OF HONORABLE ALAN J. DIXON
A U.S. SENATOR FROM ILLINOIS

Mr. Chairman, I am pleased to be here again this morning to receive testimony on the reauthorization of the Commodity Futures Trading Commission.

At yesterday's hearing I had a meaningful exchange with Susan Phillips, Chairman of the Commodity Futures Trading Commission, on the matter of audit trails.

For this reason, I would hope that each of our witnesses will address the question of audit trails, and perhaps give the members of the committee some suggestions about how this matter might be resolved.

Thank you, Mr. Chairman.

Statement of
John M. Damgard, President
Futures Industry Association

Mr. Chairman and members of the Committee, I am John Damgard, President of the Futures Industry Association accompanying me today is Arthur Marcus, Chairman of the FIA and Senior Vice President of PaineWebber Inc. The FIA is the national trade association for the commodity futures and options industry. Our regular membership is composed of over 100 brokerage houses, called "futures commission merchants" or "FCMs". FIA - member FCMs are estimated to transact over 80% of the public customer trade on US commodity exchanges. Our association also counts among its membership, all US exchanges and many law and accounting firms, foreign exchanges and foreign brokerage houses and banks. While we value all of our members and strive to represent the "industry" as a whole, our roots are in the brokerage community and we remain, primarily an FCM association.

FCMs are the industry's link to the trading public. Our members serve public customers, be they farmers, mutual funds, pension plans, savings and loans or local or foreign governments. FCMs must assure the public that these markets are fair and answer to the public on those occasions when the perception is to contrary. Thus, we have a vital interest in thoughtful regulation of the market place and increased efficiency in the transaction of business. Our public demands this and we can accept nothing less.

The FIA recommends reauthorization of the Commodity Futures Trading Commission for a six year period. As I have observed the growth of the Commission over the past eleven years, I believe it has done a credible job in regulating -without hindering a marketplace that has grown 5 fold since 1974 and introduced 169 new futures and options contracts. The existence of a credible federal regulator has allowed these markets to grow and prosper and enjoy the participation of large institutional users and the public in general.

While the FIA is generally pleased with the evolution of regulation under the CFTC, there are a number of programs and issues, some of which are regulatory and not legislative in nature, about which I would like briefly to comment:

Options: A great deal of attention has been focused in the past year on the default of Volume Investors Corporation and its impact on the Commission's option program. As a result of the Volume default, the Commission identified what they believe to be various weaknesses in the current regulatory framework. Those perceived weaknesses and potential remedies are the subject of ongoing debate within the industry and between regulator and regulated. It is our hope that the end result will be a rational regulatory framework that does not drive the industry to its knees. Nevertheless, the options program should not suffer from a single controversial incident, nor should the current restrictions on expansion of the program be maintained. Presently, the exchanges are limited to a maximum of eight (8) non-agricultural options and two (2) agricultural. Particularly in the agricultural context, where there have been no problems whatsoever, the restrictions should be eliminated.

Insurance: The controversial Volume Investors problem gave rise to renewed cries by some that the commodity futures and options industry should provide insurance or customer account protection in some form. In response, the Commission ordered the NFA to undertake a study of customer account insurance. We anxiously await the results of that study.

The importance of customer confidence in the financial integrity of the futures markets is tremendous, and I would add, well-deserved. Between 1971 and 1984 customer losses amounted to $9.7 million in the commodities industry. During the same 13 year period, total securities customers claims amounted to about $690 million, for which SIPC paid out $153 million. Ten million dollars in securities customer losses were not covered by SIPC. Thus even with the SIPC program, customer losses in the securities area exceeded those in commodities. Insurance, in the securities industry and other segments of the financial marketplace, including banking, has presumably played a significant role in the protection of customer funds, but at what cost? Do market users exercise less than sound business judgement in selecting a firm when there is an insurance program in place? Are the firms themselves less cautious in their hiring of employees, screening of customers or handling of accounts and cash? Do the self-regulatory organizations enact fewer, or less stringent rules designed as preventive measures? If the answer to any of these questions is "yes", then the trade-off for having insurance cannot be taken lightly. While the present system is certainly not perfect, it has worked remarkably well for many years. The best "insurance" is a strong clearing organization, properly capitalized firms and a sound self-regulatory framework with competent CFTC oversight that is effectively and consistently enforced.

Hedging: The CFTC's hedging definition, promulgated prior to the development of the financial futures markets is not appropriate for today's financial futures markets. Rule 1.3(z), which defines hedging, was promulgated in 1977 for the agricultural markets; it is not adaptable to the financial futures and options markets, or their institutional participants. As a result, the activities of commercial and institutional users of financial futures have been unduly restricted. The situation is long overdue for reexamination and promulgation of a more realistic hedge definition for financial futures.

Position Limits and Aggregation: Related to the issue of the dated hedging definition are speculative position limits, which limit the number of non-hedging positions that may be held in any futures or option contract, and the CFTC's current aggregation policy, which requires a trader to combine the positions in all accounts owned or controlled by the trader for purposes of applying speculative position limits. FIA believes that the existing levels of speculative position limits and the CFTC's aggregation policy are hampering legitimate uses of the commodities markets, without any countervailing regulatory benefits. Thus, existing CFTC limits on agricultural futures and exchange-set limits on other contracts adopted at the CFTC's insistence are frequently unrealistic in view of the substantial growth in the supply of the underlying commodities and the expansion and growing internationalization of the agricultural and other commodity markets over the years. The futures and option markets cannot serve the needs of hedgers seeking to lay off their risks without the active participation of traders who provide the necessary depth and liquidity in the markets. Thus, the level of speculative position limits should be raised. Also, FIA believes that traders, including commodity pools and other institutional participants, should not be required to aggregate positions in all accounts owned by them if those separate accounts are being traded independently of one another. This is another unnecessary restriction on the liquidity of the markets. The potential for disruption or manipulation of commodities market prices, which is the rationale for speculative position limits and aggregation, is not present where a trader merely owns a position in an account, but does not control trading in that account. The CFTC needs to rethink its policies on speculative position limits and aggregation in light of the changing conditions of the commodities markets and the growing needs served by commodity futures and options.

Off-exchange transactions: The FIA urges the Congress and the Commission to be extremely cautious in considering any legislation or regulation in the very broad area of "off-exchange" transactions. There is clearly a legitimate role for the CFTC in enforcement of Section 4 of the Act which requires that all futures contracts be traded on a designated exchange. It does not follow however, that all off-exchange transactions violate Section 4. There are a myriad of vitally important non-exchange financial transactions that cannot legitimately be characterized as off-exchange futures, and should not be. We fear that "the easy way out" for regulators would be to characterize these transactions in such a way -- as off-exchange futures -- to destroy these markets, which legitimately provide hedging and investment opportunities for large and knowledgeable participants. The interbank currency market, interest rate swaps, forward rate loans/deposits, cross-currency rate swaps, Eurocurrency loans with marketable caps and many more financial transactions and arrangements provide corporate treasurers and financial officers with the flexibility to operate in their economically most efficient manner.

In some instances, these varied financing arrangements, and perhaps some not as yet even developed, will best serve commerce. It would be a tragic mistake to interfere in such sophisticated markets, without first fully exploring the ramifications of such intervention.

Enforcement: The FIA continues to be concerned about what has become known in the enforcement context as "double jeopardy". The exchanges have the authority, pursuant to Section 8c of the Act, to bring disciplinary proceedings in accordance with their own rules, against their members, for a wide variety of offenses. The Commission has in the past, often filed complaints against those same exchange members for the same violations for which they have already been prosecuted and sanctioned by the exchange. Rather than reprosecute, the CFTC should be utilizing its authority to review exchange actions. The CFTC's practice of reprosecuting can stifle the exchanges' own disciplinary proceedings and discourages offending parties from cooperating with the exchange disciplinary body.

Audit Trail: The CFTC published a final rule on January 14 requiring that each side of all trades have, on the trade register, an execution time identified to the nearest minute. This final rule raises many questions about whether liquidity of the markets and the speed of trade execution would be adversely affected. In the past week, what appears to be a viable system of timing has been jointly proposed to the CFTC by the Chicago Board of Trade and the Chicago Mercantile Exchange. The FIA strongly encourages the CFTC and the exchanges to fully develop this proposal to determine whether it can provide a meaningful, accurate audit trail. The audit trail issue presents highly technical problems whose resolution lie properly in the regulatory arena. We applaud the motives of the CFTC and look forward to continuing progress, where the CFTC, FCMs and exchanges work together to foster greater public confidence in the markets.

NFA: The FIA applauds the progress of the NFA over the past three years. It has proven itself to be a self-regulator responsive to its oversight authority. We join with the NFA and the exchanges in opposing the CFTC's request for additional rulemaking authority over the NFA.

Mr. Chairman, the FIA appreciates this opportunity to present its views to the Committee. The FIA offers the Committee the assistance of its staff and membership in this most important undertaking.

STATEMENT OF JAMES A. LAYTON, PRESIDENT, CLAYTON BROKERAGE CO. OF ST. LOUIS, INC.

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

My name is James A. Layton. I am president of Clayton Brokerage Co. of St. Louis, Inc., a full-service futures commission merchant located in St. Louis, Missouri, with twenty-seven branch offices, a substantial home office with research and clearing capabilities, and over one hundred fifty Introducing Broker agents. We have been in the commodity futures business since the early 1950's.

We are pleased to have this opportunity to offer the views of our firm in connection with your consideration of legislation to reauthorize the Commodity Futures Trading Commission.

I would first like to address my remarks to agricultural futures options and the desire of the industry to have the pilot program opened to offer additional products to market users. Contrary to some beliefs, ag options have been extremely successful. Despite generally depressed agricultural markets, they have exceeded the initial performance of non-agricultural options at a similar stage.

Clayton Brokerage clients have found agricultural options to be a useful tool in marketing farm and ranch productions. The theoretical advantages commodity options provide producers in stabilizing and enhancing their incomes are well documented in the myriad publications available on options trading. We would like to provide some real live examples of how our farmer/rancher clients have benefited from the availability of commodity options.

While we have found all options to be useful to individual customers, our experience has been that cattle options have been the most popular with agricultural hedgers.

Cattle options have also found ready acceptance in the cattle industry at large. On February 18, one and one half years after introduction, open interest in cattle options totaled thirty thousand contracts. It took more than four years for cattle futures to attain the same level of participation.

Recently, the number of cattle options traded has averaged 23% of futures volume, still below, but rapidly approaching the 41% for Treasury Bonds, by far the largest options market in the world. Over the past year, cattle options volume has grown 680% against a 350% growth rate for T-Bonds.

By many standards, the cattle options market has been a success.

Since the commencement of cattle options trading on October 30, 1984, cash cattle prices at Omaha have varied from $53.35 to $66.50 per hundredweight. Feeding margins -- the value of live cattle minus feed and feeder steer costs -- averaged $5 per cwt. Just one month's variation in price could nearly wipe out the feeder's profit margin, and corn belt feeders typically hold cattle for 6-8 months.

Our clients have found Put options a convenient means of insuring against price decline -- and still benefit if prices move sharply higher. Futures markets provide a means of hedging, but don't allow the feeders to participate when prices move up. Farmer feeders are optimistic by nature but bankers don't always have their enthusiasm. Many banks now require that farmer feeders hedge their operations, providing additional security to production loans. Options provide a means for farmers to provide proof that loans are secure and still indulge their optimism.

Some producers also enjoy the lack of worry over margin calls when futures prices are moving against their futures positions. Small producers especially lack the facilities or financing for maintaining margin money in fast moving markets. With options, these producers can make deposits to cover the premium cost of a Put and not be concerned with providing additional margin money when prices decline.

Exhibit A provides a chronology of one Texas cattle feeder's use of cattle options to hedge against the risk of declining cattle prices. The rancher, who had 225 cattle on feed in early December when cash cattle were trading at $66 per hundredweight, purchased six February cattle Put options at that time. The feeders liquidated these options at expiration in late January, excepting a short futures position. In early February, he sold his cattle for $57.00 per hundredweight and liquidated the futures position. The farmer calculated his cost of production at $61 per cwt., which would have resulted in a $4 per cwt. or a nearly $10,000 loss on his 225 head of cattle. The Put options transaction netted the farmer $5.55 per cwt. profit -- more than $13,400. In summary, the farmer netted approximately $3,400 from his feeding operation with options against a $10,000 loss without options.

This is just one example of a farmer who has benefited from options trading. We have included several other examples for your examination. Of course, if prices rise, losses in options will deduct from the farmer's production income. The point is, options are providing protection in uncertain markets, and farmers are taking advantage of this valuable tool.

Next I would like to comment briefly on the proposed changes to the CFTC capital rule to reshape the futures business by changing the way firms do business in light of the recent bankruptcy of Volume Investors.

We recognize the need for firms to have adequate safeguards; however, in the interest of a competitive society, we feel it is imperative that rules not be made so restrictive that they force many firms out of business and leave the industry in the hands of a few very large corporations.

And last, regarding the one-minute trade execution recording rule, we have never had a customer complaint that related to the audit trail problem involved in the new proposed CFTC regulation. And while we do not believe there is evidence of frequent widespread market abuse, like others in the industry, we recognize that there must be a system to prevent such abuses. However, this system must be a practical one. It should not be so sophisticated, cumbersome, and complicated that it interferes with the workings of the greatest free market system in the world.

EXHIBIT A

Here is a very basic example of how one of our customers used cattle options.

APRIL 9, 1985
SITUATION: CUSTOMER CALLED -- WANTED DOWNSIDE PROTECTION
CATTLE WERE ALREADY ON FEED
PROJECTED OUT DATE -- MID-JUNE 1985
# OF HEAD ON FEED -- 372
PROJECTED OUT WEIGHT -- 1,075 (STEERS)
# OF CONTRACTS NEEDED -- 372 x 1,075 / 40,000 = 10

ACTION: ELECTED TO BUY 10 JUNE 64 CATTLE PUTS FOR .60
.60 x 40,000 x 10 = $2,400.00 + 601.60 (COMMISSION .10 x $60.16)
TOTAL OPTION COST $3,001.60
ESTIMATED BREAKEVEN BEFORE PUTS 65.00
COST OF PUTS .75 (.60 + .15 COMMISSION)
NEW BREAKEVEN 65.75
PUT FLOOR 64.00
RISK EXPOSURE ASSUMING EVEN BASIS 1.75 (65.75 - 64.00) PER CWT.
POTENTIAL PROFIT UNLIMITED (TOTAL GAIN - PREM PAID FOR OPTION)

MAY 24, 1985
OPTIONS ARE DUE TO EXPIRE
JUNE FUTURES ARE TRADING AT 63.57
WE ELECTE TO EXERCISE OPTIONS AT 64.00

JUNE 5, 1985
CATTLE ARE SOLD FOR 59.50
BUY BACK FEB FUTURES AT 59.72

ASSUMING NO PRICE PROTECTION HAD BEEN TAKEN
ESTIMATED BREAKEVEN 65.00
SELLING PRICE 59.50
LOSS 5.50 CWT. OR $21,999.45 (5.50 x 1,075 x 372)
59.12 PER HEAD LOSS

WITH PUT PROTECTION/EXERCISED INTO FUTURES
ESTIMATED BREAKEVEN 65.75
SELLING PRICE 59.50
LOSS 6.25 CWT.

OPTION EXERCISED 64.00
BOUGHT FEB AT 59.725
PROFIT 4.275 CWT.

NET LOSS 4.275 - 6.25 = 1.975
TOTAL 1.975 x 1,075 = $21.23 PER HEAD x 372 = $7,898.02
FUTURES COMM. 601.50
NET LOSS 8,499.62

IN SUMMARY IF CUSTOMER HAD NOT USED OPTIONS HIS CATTLE WOULD HAVE LOST $59.12 PER HEAD AND WITH THE OPTIONS HE LOST $22.84 PER HEAD. THE BEST THING IS THAT IF THE MARKET HAD GONE UP HE COULD HAVE PARTICIPATED IN THE MOVE.

EARLY JULY 1985
SITUATION: YEARLING STEERS HAVE BEEN PURCHASED AND WILL FINISH IN LATE NOVEMBER

# OF HEAD 186
PROJECTED WT 1,075
# OF CONTRACTS NEEDED 186 x 1,075 / 40,000 = 5

ESTIMATED BREAKEVEN	60.00
CURRENT CASH MKT	58.00
DECEMBER FUTURES	62.00

DECEMBER PUT OPTIONS:

STRIKE	PREMIUM
62	2.25
60	1.50
58	.80
56	.40

THE FEEDER WAS UNCERTAIN ABOUT MARKET DIRECTION SO HE PURCHASES A 80 PUT ONLY $2.00 OUT OF THE MONEY

ESTIMATED BREAKEVEN	$60.00
PUT COST (1.50 + .15 COMM)	1.65
NEW BREAKEVEN	$61.65
FLOOR (PUT)	60.00
RISK EXPOSURE	$ 1.50 CWT.

ON NOVEMBER 22 THE CATTLE WERE SOLD FOR 65 AT THAT TIME THE DECEMBER FUTURES WERE AT 66.90, SO THE PUTS BELOW THAT PRICE WERE NO VALUE

STRIKE	PREMIUM
60	-0-
58	-0-
60	-0-

HAD THE CUSTOMER HEDGED INSTEAD OF USING PUTS HIS UPSIDE POTENTIAL WOULD HAVE BEEN ELIMINATED AND THE RESULTS WOULD HAVE BEEN

ESTIMATED BREAKEVEN	60
SOLD DEC. FUTURES	62
NOVEMBER 22	
SOLD CATTLE	65
BREAKEVEN	60
FEEDING GAIN	5.00
SOLD DEC. FUTURES	62.00
BOT DEC. FUTURES	66.90
	4.90

NET GAIN ON CATTLE IF HE HAD HEDGED
5.00 - 4.90 = .10 CWT.
.10 x 1,075 LBS x 186 PD = $199.95

BY USING THE PUTS HE PROTECTED HIS DOWNSIDE AND LEFT THE UPSIDE OPEN AND THE RESULTS WERE

NOV 22
SOLD CATTLE 65.00
BREAKEVEN (WITH PUTS) 61.65

NET FEEDING GAIN 3.35 CWT.
3.35 x 1,075 x 195 = $6,698.32

IN SUMMARY THIS CUSTOMER THROUGH THE USE OF THE OPTIONS LIMITED HIS DOWNSIDE RISK, LEAVING THE UPSIDE OPEN. THE END RESULT WAS A PROFIT OF $6,698.32. IF THE CUSTOMER HAD NOT HAD THE CHOICE OF OPTIONS AND ELECTED TO USE THE FUTURES MARKET, HE WOULD HAVE ONLY MADE $199.95.

HERE IS A VERY BASIC EXAMPLE OF HOW ONE OF OUR CUSTOMERS USED CATTLE OPTIONS.

DECEMBER 2, 1985
SITUATION: CUSTOMER CALLED -- WANTED DOWNSIDE PROTECTION
CATTLE WERE ALREADY ON FEED
PROJECTED OUT DATE -- MID FEB. 1986
# OF HEAD ON FEED -- 225
PROJECTED OUT WEIGHT -- 1,075 (STEERS)
# OF CONTRACTS NEEDED -- 225 x 1,075 / 40,000 = 6

ACTION: ELECTED TO BUY 6 FEB. 64 CATTLE PUTS FOR 160
1.60 x 40,000 x 6 = $3,842.00 + $380.96 (COMMISSION 6 x 60.16)
TOTAL OPTION COST $4,200.96
ESTIMATED BREAKEVEN BEFORE PUTS 61.00
COST OF PUTS 1.75 (1.60 + .15 COMMISSION)
NEW BREAKEVEN 62.75
PUT FLOOR 64.00
RISK EXPOSURE NONE ASSUMING EVEN BASIS
POTENTIAL PROFIT UNLIMITED

JAN. 22, 1986
OPTIONS ARE DUE TO EXPIRE
FEB. FUTURES ARE TRADING AT 58.75
WE ELECT TO EXERCISE OPTIONS AT 64.00

FEB. 11, 1986
CATTLE ARE SOLD FOR 57.00
BUY BACK FEB. FUTURES AT 56.70

ASSUMING NO PRICE PROTECTION HAD BEEN TAKEN
ESTIMATED BREAKEVEN 61.00
SELLING PRICE 57.00
LOSS 4.00 CWT. OR $9,675.00 (4.00 x 1,075 x 225)
43.00 PER HEAD LOSS

WITH PUT PROTECTION/EXERCISED INTO FUTURES
ESTIMATED BREAKEVEN 62.75
SELLING PRICE 57.00
LOSS 5.75 CWT.

OPTION EXERCISED 64.00
BOUGHT FEB. AT 56.70
PROFIT 7.30 CWT.

NET PROFIT 7.30 - 5.75 = 1.55
TOTAL 1.55 x 1,075 = $16.66 PER HEAD x 225 = $3,748.50
FUTURES COMM. 360.00
NET PROFIT 3,388.50

IN SUMMARY IF CUSTOMER HAD NOT USED OPTIONS HIS CATTLE WOULD HAVE LOST $43.00 PER HEAD AND WITH THE OPTIONS HE MADE $15.06 PER HEAD. THE BEST THING IS THAT IF THE MARKET HAD GONE UP HE COULD HAVE PARTICIPATED IN THE MOVE.

STATEMENT OF WARREN W. LEBECK, REPRESENTING THE NATIONAL GRAIN TRADE COUNCIL

Mr. Chairman, members of the Committee, my name is Warren Lebeck. I appear before you today representing the National Grain Trade Council. I am a member of the Council's Board of Directors and Executive Committee.

The Council is a national trade association whose policy making members include grain exchanges, boards of trade and national grain marketing associations. Of particular note is the fact that those who represent these organizations on the Council are all users of the agricultural futures markets. As users of the markets they are vitally interested in how the markets function and how they are regulated. Consequently, the Council appreciates this opportunity to appear before the Committee to present its views on the CFTC.

For the most part the comments we wish to make will already have been elaborated on and our short statements only wish to reinforce what has already been said.

We support reauthorization and feel that the term should be for at least six years. The four year term is too short and requires too much time and effort on the part of Congress, the CFTC, and the industry.

We favor the recommendation that the contract approval process be shortened from one year to six months. Unfortunately, even with that change the CFTC has too many opportunities to delay approval of contracts that could be of great benefit.

User fees are not necessary and could harm self-regulation. The CFTC has given the NFA high marks for its performance and users already pay the fees that support that organization.

The Council feels that margins have been handled satisfactorily by the exchanges and there is no need to change the present system. They have provided a safe balance between protection and use.

Agricultural options have proven their usefulness. Of special note is the fact that producer groups support them. There is no longer a need for a pilot program. Agricultural options should be opened up.

With regard to leverage contracts, the CFTC should be limited to regulating contracts that are traded on licensed contract markets.

One of the serious problems for users of agricultural futures is the lack of trading in the deferred contracts primarily as a result of recent tax changes. Commercial users of the markets have been harmed by this lack of liquidity, which also reflects itself unfavorably in prices to producers, and recommend that the tax situation should be looked at. In addition, raising of speculative limits could have a positive effect, principally through encouraging funds to take a more active part in the deferred contracts.

The Council supports the CFTC's legislative proposal to eliminate the automatic stay of NFA disciplinary actions through an appeal to the CFTC. The Council, however, does oppose the CFTC recommendation for more power over NFA's rules. By their own admission NFA has worked well to date. Thus, additional authority is neither needed nor justified.

The next two items, the proposed CFTC capital rule and the audit trail proposal deserve much more discussion.

For Council members as users of futures markets, the economic viability and utility of the markets is of the utmost importance. There is a natural concern about the capitalization of exchange member firms. Yet experience in the agricultural markets has been exemplary. The manner in which the agricultural futures markets handled the volatile 1973 markets when grain prices reached all-time highs and the manner in which these same markets handled a financial problem occurring at practically the same time as the Volume Investors situation, leads the Council and its members to have great confidence in the experience and professionalism of these markets and their ability to handle financial difficulties.

The CFTC proposals would appear to further concentrate the business in fewer and fewer hands, which could only lead to greater risk should there be a problem.

It is clear that had present rules and procedures been followed in the Volume Investors situation, the problem might not have occurred or at least would have been greatly minimized.

Quite frankly, it appears clear that the CFTC has reacted with an ax when a scapel in the hands of those skilled in these matters would have sufficed. What is needed is a properly constructed capital rule carefully drawn with inputs from those who have successfully weathered financial storms.

Members of the Council are also, of course, concerned that their orders be handled correctly on the floors of the exchanges. BUT, they are more concerned that their orders be handled expeditiously. In active markets a delay of even a few seconds can mean missing the market or getting a much less satisfactory fill.

The Commission and its staff seem to have ignored the economic impact that their proposal will have and have most certainly ignored studies submitted by the Chicago Board of Trade while having made no comprehensive studies themselves. The refusal of the Commission to understand the consequences of its proposal and its effect on the public interest or even to listen, is disturbing to those who use the market and will be affected by such shortsightedness.

This leaves Council members and other users of the market faced with a dilemma -- which is the greater threat -- the possibility that an order will be mishandled or the reality that one minute time recording will delay executions? After reviewing the audit trail proposals submitted by the Chicago Board of Trade and the Chicago Mercantile Exchange, the Council and its members are convinced that these give adequate protection against possible abuse without having to disrupt market activity.

One also wonders if the CFTC has considered the fact that its proposal seems to give any broker an automatic excuse for unsatisfactory fills -- "Sorry, I was time recording executed trades when the market moved."

One final comment. When reviewing the performance of the CFTC I am reminded of a definition of an economist that I have heard -- an economist is one who observes something that works and then spends time wondering if it will work in theory.

Any comments about the CFTC in this testimony are intended to be constructive. There is no need to merge the CFTC with any other agency. What is needed is more appreciation of what the markets do and more appreciation for the experience of those who have kept their markets functioning successfully lo these many years. A little more responsiveness to the industry as a whole is all that is needed.

Again, our thanks for the privilege of presenting our views.

STATEMENT OF THE NATIONAL GRAIN AND FEED ASSOCIATION BY A. JOSEPH CRAMBLIT before the COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY, U.S. SENATE, REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

FEBRUARY 20, 1986

Mr. Chairman and Members of the Committee: My name is A. Joseph Cramblit. I am president of Geldermann Inc., Chicago, Illinois. Geldermann Inc. is a member of the National Grain and Feed Association and I am presenting this statement on behalf of the Association. We appreciate the opportunity to express our views regarding S. 2045, the reauthorization of the Commodity Futures Trading Act.

The membership of the National Grain and Feed Association encompasses 1,200 companies nationwide and is comprised of every segment of the grain and feed industries -- country elevators, terminal elevators, merchandisers, exporters, feed manufacturers and dealers, and primary food processors (e.g. grain millers and oilseed processors).

Members of the Association rely heavily upon the futures markets to hedge purchases and sales of grain and/or grain products.

The contemporary concept of futures trading -- that which is conducted on organized commodity markets under rules and regulations promulgated by the exchanges -- had its practical beginning in Chicago more than 100 years ago. It was the grain trade that pioneered these efforts and basic field crops -- grains -- were the commodities first traded on these exchanges. In the ensuing decades futures trading has expanded to other commodity sectors and commodity futures markets have proved to be efficient and viable marketing mechanisms, not only for the agricultural industry but for other segments of the nation's economy as well. Futures markets have provided a valuable, open, competitive forum in which the vitally important price discovery process can take place in a free market environment.

The U.S. grain industry is proud of the role it played in the development of commodity futures markets. It is pleased with the expansion that has transpired in the futures industry. The National Grain and Feed Association believes it has been a constructive, positive force during this development and growth process. It is a matter of record that this Association has been a responsible cooperative counselor to the Congress and other branches of government, and has aided government as it has considered legislation and regulatory proposals pertaining to futures markets.

Continuation of viable futures markets is critical to a competitive and efficient marketplace for agriculture. The price discovery mechanism provided by the futures markets benefit the entire nations' economy as it ensures fair prices are offered to both producers and consumers alike. Just as important to the smooth functioning of a competitive market place is the risk management mechanism provided by futures and options markets. Without the opportunity to shift risks via these markets, commercial interests would be unable and/or unwilling to offer many of the marketing services available today. And the cost of providing marketing services would be substantially greater in the absence of futures markets. Futures markets are truly the cornerstone of efficient marketplace.

The National Grain and Feed Association believes that the Commodity Futures Trading Act of 1982 has served the industry well. We further believe that the current legislative extension process should be confined to management-type improvements in the existing law rather than the adoption of sweeping new legislation.

This Association strongly recommends that the regulatory agency (the Commodity Futures Trading Commission) continues to be an independent agency. We believe, as we have believed since the creation of the CFTC, that all futures markets should be regulated by an independent regulatory body. We recommend that no substantive change be made in the Act as it relates to the jurisdiction of the CFTC pertaining to futures markets.

While not under active consideration, the issue of margin-setting authority being vested in one or more government agencies remains a primary concern for our industry. It is our firm belief that margins on futures contracts should continue to come under the sole purview of the individual futures markets.

There seems to be continuing confusion about futures market margins that cause some to believe that there is a great similarity between margins on securities and margins on futures contracts. The purpose of margins in securities markets is clearly stated in the Securities and Exchange Act of 1934 whereby margin refers to the required level of down payment on credit purchases of securities.

In contrast, the purchase and sale of a futures contract on margin is not a credit transaction. The only capital asset involved is the commodity itself which can only be used after delivery occurs at which time ownership is financed through otherwise established credit facilities not under the control of commodity exchanges, chiefly the banking system. Since no title is conveyed prior to delivery and no loan is extended, no credit is involved in a futures transaction, hence the word "margin" has an entirely different meaning in this context, and the purpose of margins is different.

The purpose of margins in futures markets is to ensure the financial integrity of all futures contracts trading on these exchanges. The purpose of margins in securities markets is to serve as a down payment. The function of securities markets is to transfer title, from one owner of a security to another. The function of futures markets is not to transfer title, rather it is to transfer price risk. Recognition of the differences in function between these institutions should help in understanding the differences between them regarding margin concepts.

We do not believe any government agency, no matter how enlightened or well-intentioned, possesses the capability to manage the margin responsibilities for futures markets. We do not believe any government agency could be sufficiently responsive to changes in margin levels that frequently must be effected in an environment of fast-breaking changes that necessitate rapid, immediately implemented, decisions. In our judgment, only the individual exchanges have the capability to deal with the logistical realities of margin-setting responsibilities regardless of the underlying commodity.

Under the current Act and regulations, cash forward contracting is not regulated by CFTC. Encumbering the efficient grain marketplace with federal regulations would only distort the responsive nature of the grain market's purchaser and seller needs. The National Grain and Feed Association strongly recommends that no added provisions for the regulation of cash commodity forward-contracting be included in the extension of this legislation.

One of the most significant changes in futures exchange activity authorized by the Commodity Futures Trading Act of 1982 was the pilot program for agricultural options. This program has been highly successful. Although limited in scope, options contracts for agricultural commodities have provided producers and commercial hedgers many new alternatives for hedging their risks.

Producers, commodity buyers, elevator operators, processors and exporters have just begun to realize the vast potential uses of options, the innovations and opportunities they will bring to marketing and purchasing commodities. As price supports offered in government programs are adjusted to allow the U.S. to compete in export markets, producers will find options markets provide them with new alternatives for developing production and marketing strategies. Options, offering a guarantee of a miniumum price without limitation on potential gains from market rallies, may become increasingly attractive to producers and hedgers during coming growing seasons.

Based upon results of the pilot program in options, we would support an expansion of the current program. If the pilot program continues its current degree of success, full authorization for options trading should be seriously considered.

The application of options in commercial channels has had an impact on cash grain contracting resulting in an expansion of the types of cash contracts offered to producers by buyers. Through these new cash contracts, additional producers have realized benefits from the new options markets. In an interpretative statement published in the September 30, 1985 Federal Register, the CFTC confirmed its view that these new cash contracts were forward cash contracts and not subject to CFTC jurisdiction. We agree with this conclusion and commend the CFTC for clarifying its viewpoint to industry.

We recommend that the Commodity Exchange Act, as amended, be extended for a period of six years.

The National Grain and Feed Association desires to be helpful to the Congress as it considers this reauthorization legislation. Please do not hesitate to contact the National Association regarding any questions whatsoever your Committee may have on this overall subject. I would be happy to answer any questions the committee may have.

STATEMENT OF PHILIP A. FEIGIN, ASSISTANT SECURITIES COMMISSIONER, COLORADO DIVISION OF SECURITIES AND CHAIRMAN, COMMODITIES COMMITTEE, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC. ("NASAA")

Mr. Chairman, members of the Committee, I thank you for affording me the opportunity to appear before you today to testify regarding the reauthorization of the Commodity Futures Trading Commission (CFTC). I submit this statement in my capacity as both Assistant Securities Commissioner for the Colorado Division of Securities and as Chairman of the Commodities Committee of the North American Securities Administrators Association, Inc. (NASAA), a voluntary association of securities administrators from all fifty states, the District of Columbia, the Canadian provinces, Puerto Rico and Mexico.

I would like to begin my remarks today by commenting in general terms on the present relationship between the CFTC and the states. In a word, it is excellent. The jurisdictional disputes and vitriolic attacks that characterized reauthorization hearings in the past have faded into history. Utilizing sections 6d and 12(e) of the Commodity Exchange Act, the CFTC, the National Futures Association (NFA) and the states have joined forces in a concentrated attack on off-exchange commodities-theme fraud.

This new era of cooperation is evidenced by joint investigations and enforcement actions, CFTC and NFA enforcement training seminars, the providing of expert witnesses and analysts, and perhaps most notably, the drafting of the Model State Commodity Code. Taking advantage of section 12(e) of the Commodity Exchange Act (the so-called "open-season" provision), the Model Code fills the gap between the Commodity Exchange Act and traditional "blue sky" laws (state securities laws). It provides states with a clear jurisdictional basis to act against these scams, and provides effective, swift and comprehensive enforcement tools to use against those who would violate its provisions. As of this writing, the States of Missouri and New Mexico have enacted the Code, legislation to enact it in one form or another is pending in Washington, Minnesota, Maine and Arizona, and several other jurisdictions are considering its introduction in upcoming legislative sessions. The CFTC, NFA and the states believe that the Model State Commodity Code will prove to be a very effective state weapon in the ongoing battle against boiler room fraud.

NASAA strongly supports the reauthorization of the CFTC. The Commission has done an admirable job with its all too scarce resources in regulating the contract markets in the midst of an explosion of new products and problems. Though I believe the CFTC has done its best in the off-exchange area, it is still regrettable, if not shocking, that a suspected one hundred or more boiler rooms purveying illegal futures contracts operate with near impunity in Southern California. While it is true that no amount of money or staffing will ever eliminate all fraud, the continued existence of these firms is an affront to justice. They advertise nationally, they have listed telephone numbers, they may even belong to Chambers of Commerce, and they have been in business for months if not years. They are known and identified, and yet little if anything is done about them. NASAA urges the Congress to enhance the CFTC budget so that these criminals, sapping billions from the economy each year, are finally attacked on a broad front and stopped.

Allow me to turn now to the specific proposals as contained in the CFTC's reauthorization bill. Three of the proposals fall into the general category of the enhancement of the Commission's enforcement powers, to wit: the addition of extraterritorial service of subpoena authority, the authority to seek the appointment of a temporary receiver on an ex parte basis, and the clarification of the section 4b anti-fraud provision. NASAA supports each of these proposals. The internationalization of the commodities markets has made extraterritorial service a necessity. The ex parte relief provided in section 6c of the Commodity Exchange Act has proven to be a very effective device but the true guarantee of efficacy is missing -- a temporary receiver. The addition of such authority would not really expand enforcement authority; it would merely assure the effectiveness of the authority and relief already provided.

The final proposal concerning section 4b is practical and important. However, it may be too limited. If the problem of ambiguity described by the Commission exists with regard to section 4b, it may also exist with regard to section 12(e), a provision most important to the states. It is generally accepted that section 12(e) provides that a state may apply any law available to transactions effected off-exchange except those transactions effected in compliance with section 4c or section 19(c), the options and leverage provisions, respectively. It is clearly the intent of section 12(e) to afford the states the opportunity to pursue, for instance, illegal options contracts such as London options. However, with the "subject to" language of 12(e), an argument can be made that options sold in violation of 4c are nonetheless "subject to" regulation under the section, and thus, the states are preempted from enforcing their laws against them. Therefore, NASAA supports the proposed change to section 4b but also urges the Commission and the Committee to propose equivalent changes in section 12(e).

Although NASAA has little interplay with the Commission as to the proposals involving appellate review, NFA rules and procedures, and section 9(d), we find the proposals acceptable and support their adoption.

Undoubtedly, the most controversial proposal contained in the reauthorization package is the proposed elimination of leverage contracts from separate recognition and treatment under the Commodity Exchange Act. NASAA is already on record as supporting this concept. We have voiced our support for a similar proposal made by Representative Dan Glickman in H.R. 3434.

The arguments for and against leverage have been stated repeatedly over the years. We find the arguments that leverage contracts are not in fact futures contracts to be unconvincing. The alleged and contrived distinctions between futures and leverage contracts are as transparent as the Emperor's new clothes. The Commission staff has repeatedly failed to find any economic justification for the contracts.

The concept of the leverage contract is problematic in itself. The phrase "off-exchange futures contract" should be an oxymoron. The open outcry and free price discovery of the exchange is missing in leverage. The impartial and neutral guarantees, stability and oversight afforded by exchanges and clearinghouses in the futures markets are absent in leverage. Futures customers can transfer their accounts from brokerage to brokerage, but a leverage customer is wed irrevocably to his leverage company. While many consumers shy away from the formal commodities markets based on the common knowledge recognition of volatility and risk, they may be lured to leverage investments by vague allusions to gold ownership and a hedge against inflation for the future.

Let us suppose for a moment that leverage contracts never developed, and today a brokerage firm were to come before the Congress and propose an amendment to the Commodity Exchange Act allowing the creation of a radically new instrument -- an off-exchange, long term futures contract wherein the brokerage firm would take one side of the contract and the customer the other. We believe it likely if not certain that the proposal would be summarily rejected.

There is no reason or justification for leverage contracts. In some respects, they are inherently unfair to the consumer. If there is true consumer demand for such products, they should be and will be developed at the exchange level. Off-exchange futures trading cannot be allowed to continue and should be made uniformly illegal. NASAA wholeheartedly endorses and supports the CFTC's proposal with regard to leverage.

I thank you for your kind attention and will be glad to answer any questions I can.

STATEMENT OF GREGORY C. GLYNN, ESQ., OF WASHINGTON, D.C. BEFORE THE SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

REGARDING PROPOSAL TO REPEAL THE AUTOMATIC STAY PROVISIONS AND MANDATORY ORAL ARGUMENT REQUIREMENTS OF SECTIONS 17(h) AND (i) OF THE COMMODITY EXCHANGE ACT, 7 U.S.C. §21(h) AND (i)

FEBRUARY 20, 1986

Mr. Chairman, Members of the Committee: My name is Gregory C. Glynn, and I am an attorney from Washington, D.C. It is my privilege to appear before you today in connection with the Hearings on the 1986 Reauthorization of the Commodity Futures Trading Commission. During the period 1979 through early 1983, it was my good fortune to serve as Associate General Counsel for Litigation for the CFTC. I am presently engaged in the private practice of commodity law in Washington, D.C., and am Chairman of the International Commodity Regulation Committee of the International Law Section of the American Bar Association.

I come before you today because of my concern as a lawyer and erstwhile teacher of Constitutional law about certain Amendments proposed by the CFTC to Sections 17(h) and (i) of the Commodity Exchange Act ("CE Act"), 7 U.S.C. §21(h) and (i). In its reauthorization package, the CFTC recommends abolishment of the Automatic Stay provisions and mandatory requirement for Oral Argument currently contained in Section 17(h) of the CE Act, 7 U.S.C. §21(h). As you know, Sections 17(h) and (i) deal with Commission review of disciplinary actions taken against members by the National Futures Association or "NFA."

Our firm from time to time represents before the CFTC and in federal courts, various individuals and firms engaged in the commodities business. Together with John F. Walter, Esq. of Los Angeles, California, we have represented an individual who was twice sanctioned by a summary procedure known as an MRA by the National Futures Association. The propriety of those sanctions is currently on appeal to the Commission.

Our particular and instant concern arises from the language contained in Sections 301 and 302 of the Bill, which proposes to amend Sections 17(h) and (i) of the CE Act, 7 U.S.C. §§21(h) and (i), to delete the Automatic Stay provisions and Right to Oral Argument set forth in the current version of Sections (h) and (i) of the CE Act. Copies of the Proposed Amendments to Sections 17(h) and (i) (Sections 301 and 302 of S.2045) are attached hereto as Exhibit "A".

The basis of our concern is simply that the

Automatic Stay and Oral Argument provisions of current Sections 17(h) and (i) provide a safety valve and check on the use by the National Futures Association ("NFA") of a summary proceeding known as a Member Responsibility Action ("MRA"). A copy of NFA Compliance Rule 3-12 describing the MRA procedure is attached hereto as Exhibit "B".

The NFA Procedure known as the MRA allows the NFA to take a summary and ex parte action against a member without a prior hearing. Such action could not be taken by the CFTC itself or, indeed, by any government agency. Membership in the NFA is as a practical matter compulsory and not voluntary since Section 17(m) of the CE Act, 7 U.S.C. §21(m), provides that the CFTC may allow the NFA to impose compulsory membership on the industry. Indeed, NFA By-law 1101 prohibits its members from trading in any way with non-members of the NFA. A copy of NFA By-law 1101 is attached hereto as Exhibit "C".[1]

The very essence of the Government's dealing with all of its citizens is that fundamental fairness be observed at all times. Thus, the Fifth Amendment to the U.S. Constitution provides: "No person shall . . . be deprived of life, liberty or property without due process of law."

A United States District Court may grant a temporary restraining order ("TRO") only pursuant to the provisions of Rule 65(b), Fed. R. Civ. P. Rule 65 requires proof of immediate and irreparable injury and an attorney's certificate as to why notice to the opposing side cannot or should not be given, in order for a TRO to issue. A TRO expires at the end of ten (10) days and may be extended or rolled over only for one additional ten day period. In the event of an ex parte TRO, a preliminary injunction must be set down for hearing at the earliest possible time. Rule 65, Fed. R. Civ. P.

The imperative of prompt and fair review of injunctions has led to the doctrine that orders of federal courts granting, continuing, modifying, refusing or dissolving injunctions are appealable of right as interlocutory orders under 28 U.S.C. §1292(a), notwithstanding the general rule that only "final decisions" of the District Courts are appealable. 28 U.S.C. §1291.

The Congress has generally denied the right to seek ex parte restraining orders or injunctive relief to the CFTC itself in Section 6c of the CE Act, 7 U.S.C. §13a-1.[2]

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[1] Absent express statutory authorization and imprimatur, such a trading prohibition would appear to violate the Anti-Trust Laws as an unlawful restraint of trade. See 15 U.S.C. §1.

Moreover, the CE Act provides that the CFTC may use its administrative procedures to prohibit a person from trading or to suspend or revoke his registration only upon the issuance and service of a Complaint upon that person and a hearing which may be held not less than three days after service of the Complaint. Section 6(b) of the CE Act, 7 U.S.C. §9. Indeed, the CFTC is required to grant a hearing to any person whom it proposes to refuse to register under Section 8a(3) of the CE Act, 7 U.S.C. §12(a)3, unless that person is subject to an existing statutory disqualification which has resulted from a previous hearing. Section 8a(2) of the CE Act, 7 U.S.C. §12a(2).

The import of the foregoing analysis is simply that the CFTC could not do to an individual Registrant what the NFA has done utilizing the summary MRA procedure. The CFTC as a governmental agency is limited by its enabling statute, the Commodity Exchange Act, and by Constitutional due process.

Ironically, the NFA takes the position that it has no due process limitations because of its status as a private organization. But, we submit, that by requiring compulsory membership in the NFA under Section 17(m) of the CE Act and allowing NFA Rule 1101 which bars all NFA Members from dealing with non-members, the CFTC has in effect "deputized" the NFA, delegated clearly governmental functions such as registration and discipline to it and conferred a "quasi-governmental" status upon it. Because of the foregoing, we believe that the NFA ought to observe the principles of "fundamental fairness". The very essence of due process is in the words of Mr. Justice Frankfurter: "The right to be heard before being condemned to suffer grievous loss of any kind." Joint Anti-Fascist Refuge Committee v. McGrath, 341 U.S. 123, 168 (1951) (Mr. Justice Frankfurter, concurring).

Indeed, the arbitrary and secret procedures utilized by the NFA in issuing the two MRAs ex parte and without prior notice and hearing echo the actions of the Executive Branch in designating, without notice or hearing, certain charitable organizations as Communist to the Loyalty Review Board which in turn disseminated the information to all federal departments and agencies. In Joint Anti-Fascist Refuge Committee v. McGrath, 341 U.S. 123, the Supreme Court condemned such actions and found that such conduct stated a cause of action for defamation. As Mr. Justice Frankfurter stated in his concurring opinion:

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[2] A federal court may issue an ex parte restraining order to the CFTC only to prohibit "any person from destroying, altering, disposing of, or refusing to permit authorized representatives of the Commission to inspect, when and as requested, any books and records or other documents or which prohibits any person from withdrawing, transferring, removing, dissipating or disposing of any funds, assets, or other property"). Section 6c of the CE Act, 7 U.S.C. § 13a-1.

> Man being what he is cannot safely be trusted with complete immunity from outward responsibility in depriving others of their rights. At least such is the conviction underlying our Bill of Rights. That a conclusion satisfies one's private conscience does not attest its reliability. The validity and moral authority of a conclusion largely depend on the mode by which it was reached. Secrecy is not congenial to truth-seeking and self-righteousness gives too slender an assurance of rightness. No better instrument has been devised for arriving at truth than to give a person in jeopardy of serious loss notice of the case against him and opportunity to meet it. Nor has a better way been found for generating the feeling, so important to a popular government, that justice has been done.
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> Id. at 171-172.

It is thus not only important that justice be done and the process be fair, but that it also must manifestly appear to be such. Id. at 172 n. 19.

The Automatic Stay provisions and prompt Commission review currently contained in Section 17(h) of the CE Act, 7 U.S.C. §21(h), are a last bastion of protection for a Commission Registrant and compelled NFA Member from the arbitrary and secret ex parte expulsion decisions of the NFA under the MRA provisions of NFA Compliance Rule 3-12. What the NFA has done here, the Commission itself could not do under Section 17 (1)(2) of the CE Act to an NFA Member nor could the Commission take such actions ex parte and without prior hearing under Sections 8a(1) through (4) of the CE Act, 7 U.S.C. §12a(1)-(4). Indeed, we submit that NFA Compliance Rule 3-12 is contrary to the Rule requirement for "a fair and orderly procedure with respect to the disciplining of members" set forth in Section 17(b)(9) of the CE Act itself, 7 U.S.C. §21 (b)(9).

Nor is the MRA used solely by the NFA for true emergency situations. While market emergencies may properly be amendable to consideration and summary treatment under the CFTC's emergency powers contained in Section 8a(9) of the CE Act, 7 U.S.C. §12a(9), or under the emergency rules of designated contract markets or exchanges, garden variety disciplinary proceedings against members are properly handled with prior hearings fairly conducted before the imposition of sanctions.

In reviewing NFA sanctions, including an MRA, we submit that the CFTC has an obligation to use a "Constitutional due process" analysis with regard to NFA procedures. Simply put, if the CFTC can not take certain action because of Constitutional due process limitations imposed by the Fifth Amendment or because of the hearing and fairness limitations imposed by the CE Act, the CFTC cannot allow the NFA to do such at its direction and should not affirm or approve NFA actions which do not meet these CFTC standards.

It is to be noted that there are no detailed, adequate and fair NFA rules for the conduct of NFA disciplinary hearings, including MRA, and the CFTC has not imposed a requirement on the NFA that such detailed evidentiary and procedural rules be created and followed before the issuance of MRAs.

In view of the stated shortcomings in the NFA hearing procedures, we submit that it is most appropriate to continue the Automatic Stay provisions and provisions for Oral Argument contained in Section 17(h) and (i) of the CE Act, 7 U.S.C. §21(h) and (i).

The shortcomings of the NFA procedures specified above regarding the MRA prudently suggest that the Registrant be protected by the Commission from wholesale and irreversible deprivation of rights and that the Automatic Stay protect these rights until a reasoned Commission decision. A reasoned Commission decision on the propriety of continuing the Automatic Stay, should be capable of being made within a week or ten days. This is the time period period generally used by Courts of Appeals in determining stay questions on appeals from District Courts. Oral Argument promotes a reasoned Commission decision on the Stay and gives the Registrant the perception of fairness which is so important to our system of justice.

We trust that the foregoing observations and comments may be of some help to the Committee in dealing with the proposed amendments to Sections 17(h) and (i) of the CE Act, 7 U.S.C. §21(h) and (i). We oppose the proposed Amendments on the grounds that they deprive a Registrant of his last and best hope for an element of due process and fundamental fairness for coping with the strictures of an MRA imposed *ex parte* by the NFA.

Thank you.

EXHIBIT "A"

Title III--Registered Futures Associations

Disciplinary Actions

SEC. 301. Section 17(h) of the Commodity Exchange Act (7 U.S.C. 21(h)) is amended to read as follows:

"(h)(1) If any registered futures association takes any final disciplinary action against any member thereof or any person associated with such a member or denies admission to any person seeking membership therein, or bars any person from being associated with a member, the association shall promptly file notice thereof with the Commission. The notice shall be in such form and contain such information as the Commission, by rule, may prescribe as necessary or appropriate in furtherance of the purposes of this Act.

"(2) Any action with respect to which a registered futures association is required by paragraph (1) of this subsection to file notice shall be subject to review by the Commission, on its own motion, or upon application by any person aggrieved thereby filed within thirty days after the date such notice was filed with the Commission and received by such aggrieved person, or within such longer period as the Commission may determine. Application to the Commission for review, or the institution of review by the Commission on its own motion, shall not operate as a stay of such action unless the commission otherwise orders, summarily or after notice and opportunity for hearing on the question of a stay (which hearing may consist solely of the submission of affidavits or presentation of oral arguments). The Commission shall establish for appropriate cases an expedited procedure for consideration and determination of the question of a stay."

Commission Review of Association Action

SEC. 302. Section 17(i) of the Commodity Exchange Act (7 U.S.C. 21(i)) is amended to read as follows:

"(i)(1) In a proceeding to review a final disciplinary action taken by a registered futures association against a member thereof or a person associated with a member, after appropriate notice and opportunity for hearing (which hearing may consist solely of consideration of the record before the association and opportunity for the presentation of supporting reasons to affirm, modify, or set aside the sanction)--

"(A) if the Commission finds that such member or person associated with a member has engaged in such acts or practices, or has omitted such acts, as the association has found him to have engaged in or omitted, and that such acts or practices, or omissions to act, are in violation of the rules of the association as have been specified in the determination of the association, and that such provisions are, and were applied in a manner, consistent with the purposes of this Act, the Commission, by order, shall so declare and, as appropriate, affirm the sanction imposes by the association, modify the sanction in accordance with paragraph (2) of this subsection or remand to the association for further proceedings; or

"(B) if the Commission does not make any such finding it shall, by order, set aside the sanction imposed by the association and, if appropriate, remand to the association for further proceedings.

"(2) If, after a proceeding in accordance with paragraph (1) of this subsection, the Commission finds that any penalty imposed upon a member or person associated with a member is excessive or oppressive, having due regard to the public interest, the Commission shall by order cancel, reduce, or require the remission of such penalty.

"(3) In any proceeding to review the denial of membership in a registered futures association or the barring of any person from being associated with a member, if the Commission, after appropriate notice and hearing (which hearing may consist solely of consideration of the record before the association and opportunity for the presentation of supporting reasons to affirm, modify, or set aside the sanction), determines that the specific grounds on which such denial or bar is based exist in fact, that such denial or bar is in accordance with the rules of the association, and that such rules are, and were applied in a manner, consistent with the purposes of this Act, the Commission shall by order dismiss the proceeding; otherwise, the Commission shall by order set aside the action of the association and require it to admit the applicant to membership; therein, or to permit such person to be associated with a member.

"(4) Any person (other than a registered futures association) aggrieved by a final order of the Commission entered under the provisions of this subsection may file a petition for review with a United States court of appeals in accordance with section 6(b) of this Act."

Rule Review Procedures

SEC. 303. Section 17(j) of the Commodity Exchange Act (7 U.S.C. 21(j)) is amended by striking out the third sentence thereof.

Alteration or Supplementation of Association Rules

SEC. 304. Section 17(k) of the Commodity Exchange Act (7 U.S.C. 21(k)) is amended by--

(1) striking out "title" in subsection (1) thereof and inserting in lieu thereof "section"; and

(2) amending subsection (2) thereof to read as follows:

"(2) The Commission may in writing request any registered futures association to adopt any specified alteration or supplement to its rules with respect to any of the matters hereinafter enumerated. If such association fails to adopt such alteration or supplement within a reasonable time, the Commission is authorized by order to alter or supplement the rules of such association in the manner theretofore requested, or with such modification of such alteration or supplement as it deems necessary if,...."

EXHIBIT "B"

(iii) Censure or reprimand.

(iv) A monetary fine, not to exceed $100,000 for all violations found.

(v) Order to cease and desist, or any other fitting penalty or remedial action not inconsistent with this rule.

SEC. 5209.2 (b) Authority of Appeals Committee to Alter Penalty.

The Appeals Committee may increase, decrease or set aside the penalties that were imposed by the Regional Committee, or may impose other and different penalties, as it sees fit, subject to the requirements and limitations in paragraph (a) above.

SEC. 5209.3 (c) Payment of Fines.

All fines shall be paid to the NFA Treasurer within the time prescribed in the decision, and may be used for general NFA purposes. A person who fails to pay a fine on time may, after 7 days written notice, be summarily suspended from membership or association with a Member, by order of the President, until the fine is paid.

SEC. 5215 Rule 3-12. Member or Associate Responsibility Actions.

SEC. 5215.1 (a) Nature of Action.

A Member or Associate may be summarily suspended from membership, or association with a Member, may be required to restrict its operations (e.g., restrictions on accepting new accounts), or may otherwise be directed to take remedial action, where the President, with the concurrence of the FNA Board of Directors or Executive Committee, has reason to believe that the summary action is necessary to protect the commodity futures markets, customers, or other Members or Associates. Notice of such summary action shall be given promptly to the Commission.

SEC. 5215.2 (b) Procedure.

The following procedures shall be observed in actions under this Rule:

(i) The subject of the action (the "Respondent") shall, whenever practicable, be served with a notice before the action is taken. If prior notice is not practicable, the Respondent shall be served with a notice at the earliest opportunity. This notice shall (A) state the action taken or to be taken; (B) briefly state the reasons for the action; and (C) state the time and date when the action became or becomes effective and its duration.

(ii) The Respondent shall be given an opportunity for a hearing promptly after the summary action taken. Any such hearing shall be conducted before the appropriate Regional Committee (see Bylaw 704) under the procedures of paragraphs (b)-(d) of Rule 3-6.

(iii) The Respondent shall have the right to be represented by an attorney-at-law or other person in all proceedings after the summary action is taken, but the Regional Committee may bar from the proceeding any representative for dilatory, disruptive, or contumacious conduct.

(iv) Promptly after the hearing, the Regional Committee shall issue a written and dated decision affirming, modifying or reversing the action taken, based upon the evidence contained in the record of the proceeding. A copy of the decision shall be furnished promptly to the Respondent and the Appeals Committee, and the Commission. The decision shall contain:

  (A) A description of the action taken and the reasons for the action;
  (B) A brief summary of the evidence received at the hearing;
  (C) Findings and conclusions;
  (D) A determination as to whether the summary action that was taken should be affirmed, modified or reversed; a declaration of any action to be taken against the Respondent as the result of that determination; and the effective date and duration of that action; and
  (E) A statement that any person aggrieved by the action may have a right to apply, within 30 days after the action has been taken, to the Commission for review of the action.

SEC. 5215.3 (c) Appeal.

The Respondent shall have no right to appeal a final action taken under this Rule.

SEC. 5125.4 (d) Review.

The Appeals Committee may on its own motion review a Regional Committee decision issued under paragraph (b)(iv) above, by giving written notice to the Respondent of its decision to review within 15 days of the date of the decision. The review shall be conducted in accordance with paragraphs (d), (e)(i), (e)(ii) and (f) of Rule 3-10.

SEC. 5221 Rule 3-13. Relationship Between Member or Associate Responsibility Action and Disciplinary Action.

The institution of a Member or Associate Responsibility Action (See Rule 3-12) shall not preclude the institution, at the same or any other time, of a disciplinary action (see Rule 3-2) involving the same matters or persons, nor shall any pending or completed disciplinary action involving the same matters or persons preclude a proceeding under Rule 3-12.

EXHIBIT "C"

Chapter 11

Doing Business with Non-Members

SEC. 4239 Bylaw 1101. Prohibition.

No Member may carry an account, accept an order or handle a transaction, in commodity futures contracts, for or on behalf of any non-Member of NFA, or suspended Member, that is required to be registered with the Commission as an FCM, Introducing Broker, Commodity Pool Operator or Commodity Trading Advisor, and that is acting in respect to the account, order or transaction for a customer, a commodity pool or participant therein, a client of a commodity trading advisor, or any other person, unless (a) such non-Member of NFA is a member of another futures association registered with the Commission under Section 17 of the Act, or is exempted from this prohibition by Board resolution, or (b) such suspended Member is exempted from this prohibition by the Appeals Committee.

SEC. 4245 Bylaw 1102. Effective Date of Prohibition.

The Board may establish such effective date or dates for Section 1101, as to any category or subcategory of persons or programs, as it deems appropriate in light of NFA resources and the prudent initiation of particular NFA operations and programs.

STATEMENT OF JOHN F. WALTER, ESQ., OF LOS ANGELES, CA BEFORE THE SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

REGARDING PROPOSAL TO REPEAL THE AUTOMATIC STAY PROVISIONS AND MANDATORY ORAL ARGUMENT REQUIREMENTS OF SECTIONS 17(h) AND (i) OF THE COMMODITY EXCHANGE ACT, 7 U.S.C. §21(h) AND (i)

FEBRUARY 20, 1986

Mr. Chairman, Members of the Committee: my name is John F. Walter, Esq. I am an attorney from Los Angeles, California, and am privileged to appear before the Committee. I represent a client who is involved in the very first appeal to the Commodity Futures Trading Commission ("CFTC") of a sanction imposed under a Summary NFA proceeding known as a Member Responsibility Action or "MRA."

Our concern is with the CFTC proposal to amend the Commodity Exchange Act ("CE Act") by revoking the Automatic Stay and mandatory Oral Argument Requirement set forth in Section 17(h) of the CE Act, 7 U.S.C. §21(h). We believe that the Automatic Stay provision and mandatory Oral Argument Requirement provide a valuable due process check on the otherwise unrestricted power of the NFA to impose *ex parte* sanctions through the issuance of an MRA.

By way of background, we have personal and first-hand knowledge of the National Futures Association's ("NFA") summary procedure known as a Member Responsibility Action ("MRA") by virtue of our representation of a client in two separate MRA proceedings which are currently on appeal to the Commission. Although we agree with the Commission Report which states the MRA is a "powerful" tool, we vehemently disagree with the Commission's conclusion that the MRA is an "appropriate" tool. In fact, the MRA procedure is reminiscent of the Star Chamber proceeding prevalent in England prior to its abolishment in 1641. The MRA procedure is totally devoid of procedural or substantive due process and totally offends the traditional notions of fair play and substantial justice. *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945). These conclusions are based on the following personal experiences:

MRA No. 1
Issued September 20, 1985

On September 20, 1985, the NFA, by Mr. Robert K. Wilmouth, President, without notice to the member or his counsel, issued a Notice of Member Responsibility Action Under NFA Compliance Rule 3-12 (MRA). Although the proof of service attached to the MRA indicated that it was served by mail on September 19, 1985, we did not receive the MRA until the NFA's counsel kindly messengered a copy of the MRA to us on September 27, 1985. Our client received the MRA in an envelope postmarked October 7, 1985.

The very broad provisions of the MRA prohibited our client, a licensed CTA and CPO, from

> "(1) soliciting customers; (2) soliciting, accepting, entering or forwarding any futures or options order for any customer accounts over which he has power of attorney and any commodity pool accounts which he operates except for orders liquidating open positions; and (3) distributing or disbursing any funds from any customer accounts except for the benefit of customers."

Upon receipt of the MRA, we promptly demanded a hearing on the MRA before the Western Regional Business Conduct Committee ("WRBCC"). In response to our demand for a hearing, the NFA proposed a hearing before the WRBCC in Chicago, Illinois, on October 21, 1985, or in Oklahoma City on November 4, 1985. We immediately advised the NFA's counsel that the delay in scheduling the hearing was unreasonable and we requested an immediate hearing before the WRBCC in Los Angeles. In order to obtain a prompt hearing in Los Angeles, we offered to waive the quorum requirement of the WRBCC and have the matter heard by the one member of the WRBCC who resided in Los Angeles. As a result of continuing discussions with NFA's counsel we agreed to a hearing before a three-member subcommitee of the WRBCC and the NFA agreed to conduct the hearing in Los Angeles.

The hearing was finally held on October 23, 1985 and a decision affirming the MRA was rendered on November 4, 1985 (45 days after the issuance of the MRA). On December 2, 1985, we filed an Application to the Commodity Futures Trading Commission ("CFTC") to Review a Decision of the National Futures Association's Western Regional Business Conduct Committee Affirming Member Responsibility Action and to Stay Action Pending Review Under 7 U.S.C. §21(h) and (i) and §17(h) and (i) of the Commodity Exchange Act ("Application"). On December 4, 1985, the NFA served its Request of the Commodity Futures Trading Commission for a Hearing on the Issue of Whether the NFA Member Responsibility Action Should be Stayed (Request to Vacate Stay). On December 11, 1985, we filed a Request for Oral Argument on the NFA Request to Vacate the Automatic Stay. On December 10, 1985, the NFA served its Memorandum in Opposition to Stay of Member Responsibility Action. Our Response and Opposition to the NFA Motion was filed on December 27, 1985. Although the NFA's Request to Vacate Stay was served on December 4, 1985, the Commission has failed to act on the NFA's Request as of the date of these hearings.

MRA No. 2
Issued December 24, 1985

On December 24, 1985, with the CFTC not having acted, the NFA issued a second *ex parte* MRA which suspended our client's membership in the NFA and proscribed any NFA Members from dealing with him. In order to obtain a prompt hearing the second time, we again stipulated to a hearing before a subcommittee of the WRBCC. The second hearing was held in Los Angeles on January 14, 1986. The WRBCC affirmed the MRA in its decision issued on January 28, 1986. We immediately filed a second Application to the Commodity Futures Trading Commission to Review the Decision of the National Futures Association's Western Regional Business Conduct Committee Affirming Member Responsibility Action No. 2. On January 30, 1985, we filed a Motion to Consolidate both Appeals. The NFA filed a Request to the Commodity Futures Trading Commission for a hearing on the issue of whether the NFA Member Responsibility Action should be stayed. As of this date, the Commission has not acted on either of the NFA's Requests to Vacate Stays.

As a result of the issuance of MRA on December 24, 1985, suspending our client's membership in the NFA, our client was unable to trade for his own account or conduct any business whatsoever because all NFA members were prohibited from dealing with him as a result of the MRA. Because of the draconian effects of the MRA, it is crucial for the Committee to determine if due process is afforded to a member during the hearing on the MRA which can be the most severe disciplinary proceeding against a member, i.e., expulsion and banishment.

In order to demonstrate the importance of the Automatic Stay to protect an individual's right to a meaningful and fair and impartial review of the MRA by the CFTC, we would like to share with you our personal experiences in defending our client at the hearing on the second MRA on January 14, 1986. First, it should be noted that prior to the hearings on January 14, 1986, we were afforded absolutely no notice of the charges other than the general allegations contained in the MRA which alleged ". . .Weinberg's apparent violation of the restrictions on his futures related activities imposed by the Membership Responsibility Action 85-MRA-24(W) and of Section 4d of the Commodity Exchange Act." In the absence of such information, we had no opportunity to conduct any formal investigation with respect to the factual basis of the charges or formally discover the identity or proposed testimony of the witnesses at the hearing because of the absence of any discovery procedures.[1]

The hearing commenced at 1:30 p.m.,[2] and the counsel for the NFA called three witness in its case in chief. During cross-examination of the first witness, we discovered that he had submitted a lengthy statement to NFA counsel together with documents that supported his position. Although the Chairman of the Committee initially refused our request to examine the materials provided to NFA, the documents were ultimately voluntarily produced by NFA's counsel. Unfortunately, we were not provided with an adequate opportunity to study the materials and our attempts to impeach the witness with apparent prior inconsistent statements that were contained in his statement to the NFA were totally ineffective.

During the course of the hearing, there were several motions made and legal arguments advanced on behalf of our client. The Committee summarily denied such without any legal analysis.[3] The WRBCC further abrogated our client's right to due process by allowing the NFA to introduce crucial evidence against our client in the form of an Affidavit. Although we strenuously objected that the Affidavit should not be considered because it was totally hearsay and deprived our client of an opportunity to cross-examine the Affiant, the objection was summarily overruled. Moreover, the NFA offered testimony of an expert witness at the hearing. We did not have an adequate opportunity to examine the qualifications of the expert or prepare for cross-examination of this witness. Although counsel for the NFA advised us on the day before the hearing of the identity and general nature of the testimony of this expert, we were uncertain of the specifics of the expert's testimony. Accordingly, we were unable to retain experts who would assist us in our defense.

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[1] Although there are no formal discovery procedures, NFA's counsel graciously provided informal discovery regarding the charges, identity and general nature of the testimony of the proposed witnesses and copies of documents. However, there is no obligation on the part of the NFA to provide such discovery.

[2] The hearing was originally scheduled to commence at 9:00 a.m. on January 14, 1986. However, at the request of counsel for the NFA, we agreed to continue the hearing to 1:30 p.m. because of the NFA's difficulty in producing its witnesses.

[3] Although the integrity and bona fides of members of the Committee are without question, they likely would be the first to admit that they would have appreciated the assistance of independent legal counsel.

The absence of due process in the MRA hearing was also exacerbated by our inability to compel witnesses to attend the hearing. Prior to our hearing, counsel for the NFA advised that the estranged wife of the principal witness would be at the hearing. We indicated that it was our intention to call this witness in the defense case. Unfortunately, when we were prepared to proceed with the defense case, we were informed that the witness had chosen not to appear at the hearing. We were also informed that unless witnesses voluntarily appear at the hearing that there were no procedures, i.e., subpoenas, to compel the appearance of the witness.

In addition to depriving us of the fundamental right to cross-examine witnesses, i.e., testimony introduced by affidavit, and to compel the attendance of defense witnesses, the WRBCC also deprived us of the opportunity to present our defense by virtue of the fact that the WRBCC concluded the hearing over defense objection at approximately 6:00 p.m. on the evening of January 14, 1986, at the close of the NFA case in chief. The hearing was concluded, notwithstanding a defense request to resume the hearing on the following morning so that we could attempt to persuade the missing witness to appear at the hearing. We also advised the WRBCC that we intended to call one other witness and that we wanted to prepare our client to testify.

Although it was the NFA's problem in scheduling witnesses that resulted in the postponement of the hearing from 9:00 a.m. to 1:00 p.m., the NFA objected to our request. The Committee denied our request and the hearing was concluded without a fair and realistic opportunity for the defense to present its case.

On January 28, 1986, the WRBCC affirmed the MRA, and our client's membership in the NFA was suspended. We filed an Application for Review with the Commission on the same day. If it had not been for the automatic stay provisions of the CEA, our client's business would have been destroyed prior to any Commission review of the decision.

We respectfully submit that the lack of due process and the summary MRA procedure requires a prompt Commission review and an Automatic Stay of the MRA pending such review.

In summary, the issuance of an MRA results in a concerted refusal to do business by the membership of the NFA and deprives a member of his livelihood until the application for review is filed with the Commission. Because of the summary nature of the MRA hearing and the absolute total lack of due process afforded to a member during the course of the hearing, it is respectfully submitted that the Automatic Stay provisions of the CEA are absolutely imperative to obtain independent governmental review and afford minimum due process rights to the sanctioned member.

STATEMENT OF THE INTERMARKET CLEARING CORPORATION
BEFORE THE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY
UNITED STATES SENATE

The Intermarket Clearing Corporation ("ICC") understands that the Committee is considering a number of proposed amendments to the Commodity Exchange Act (the "CEA") in connection with the reauthorization of the Commodity Futures Trading Commission (the "CFTC"). ICC urges that there be included among those amendments provisions that would clarify the CFTC's authority to permit "cross-margining" of positions in securities and commodities products relating to similar underlying assets.

This statement begins with some background information regarding ICC; then discusses cross-margining and its benefits; identifies certain potential impediments to cross-margining in the present language of the CEA; and suggests ways of eliminating those impediments.

The Intermarket Clearing Corporation

ICC is the commodity clearing subsidiary of The Options Clearing Corporation ("OCC").* ICC, which commenced operations in 1985, presently serves as the clearinghouse for commodity futures and commodity options transactions on the New York Futures Exchange, the AMEX Commodities Corporation, and the Philadelphia Board of Trade.

As its name suggests, ICC was formed with a view towards providing common clearing services for multiple markets. By offering centralized clearing for trades executed in multiple commodities markets, ICC believes that it can significantly reduce the commodities industry's back-office costs, provide an enhanced level of service, and simplify surveillance of multi-market positions.

An equally important part of ICC's charter was to develop a system for margining mixed positions in securities and commodities products relating to the same or similar underlying assets -- for example, the stock index options traded on securities exchanges and the stock index futures traded on commodity exchanges. This is commonly referred to as "cross-margining."

Cross-Margining

Margin (referred to as "initial margin" in the commodities markets) is the security deposit that a customer who enters into a futures contract or writes an option must make with his broker to guarantee performance of his obligations. The broker carrying the customer's position must in turn deposit margin with the exchange's clearinghouse to secure performance of the broker's obligations. The amount of margin required for a particular position or combination of positions depends on the degree of risk. In both the securities and the commodities markets, if a customer has a "hedged" position that limits his potential loss no matter which way the market moves, margin requirements at both the broker and the clearinghouse level are substantially lower than if the position were unhedged.

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*OCC is the issuer and guarantor of the standardized options on stocks and other underlying assets traded in the securities markets.

In recent years, securities products (in the form of standardized options) and commodities products (in the form of both options and futures contracts) have come to be traded on the same underlying assets. Such assets include stock indices, foreign currencies, and U.S. government securities. This creates opportunities for intermarket hedging. For example, a trader might hedge a short position in index options on the Chicago Board Options Exchange with a long position in index futures on the Chicago Mercantile Exchange.

Because securities exchanges and commodity exchanges have different clearing organizations, each "leg" of an intermarket hedge position must currently be carried with a different clearinghouse. Each clearinghouse "sees" only one leg of the position, and margins that leg as if the other risk-reducing leg did not exist. As a result, firms carrying positions for intermarket hedgers must meet substantially higher clearinghouse margin requirements than are warranted by the risk of their positions, taken as a whole. In turn, the hedgers themselves are subjected to unnecessarily high margin requirements by their brokers. This creates unnecessary costs for market participants and tends to discourage intermarket hedging and arbitrage, which are economically desirable activities.

"Cross-margining" refers to the process of margining both legs of an intermarket hedge as a unitary position and recognizing the limited risk of the position through reduced margin requirements. At present, there are both structural and regulatory obstacles to cross-margining. The structural obstacles result from the separate development of the securities and commodities markets, each with their own clearing systems. The regulatory obstacles result from the fact that the separate regulatory schemes for securities and commodities products established in the Securities Exchange Act of 1934 (the "1934 Act") and the CEA were enacted when there was not the commonality between the two markets that currently exists.

ICC has addressed the structural obstacles by devising a system under which positions in both securities and commodities products could be carried with a single clearing organization. This would enable clearing organizations to offer cross-margining to their members, who would in turn be able to offer cross-margining to their customers.

The regulatory obstacles arise primarily out of the segregation provisions of the CEA, which do not contemplate the possibility that positions in securities products, such as standardized options, might be carried in the same accounts as commodity futures contracts and commodity options. Similarly, the bankruptcy and insolvency provisions applicable to securities and commodities brokers presume that positions in securities products and commodities products will be carried in separate accounts, which could be administered separately in the event of the insolvency of a broker carrying positions in both types of products.

The CFTC's rulemaking authority under existing provisions of the CEA may be sufficient to enable it to surmount these regulatory obstacles and permit cross-margining. ICC currently has on file with the CFTC a petition for rulemaking, which, if acted upon, would permit ICC to offer cross-margining. However, ICC recognizes that its petition may raise questions as to the scope of the CFTC's authority. Reauthorization offers the opportunity for Congress to adopt technical amendments to the CEA that would eliminate those questions and enable the CFTC to deal with the merits of cross-margining rather than with technical issues of law.

Benefits of Cross-Margining

The most obvious benefit of cross-margining is that it would materially decrease the cost of maintaining intermarket hedges by reducing the amount of margin required to be deposited on hedged positions. This would eliminate a present deterrent to intermarket hedging and arbitrage, which can contribute significantly to the depth and liquidity of the markets involved and the efficiency of intermarket pricing.

Cross-margining would also enhance the security of clearing systems. The key role played by clearing organizations in maintaining the integrity of the nation's securities and commodities markets has previously been recognized by Congress. The Bankruptcy Code, for example, provides special protections to clearing organizations.* Cross-margining would provide clearing organizations with more effective safeguards against member defaults by reducing their reliance on fixed-value margin. The inherent weakness of margin systems is that they utilize cash or other assets of fixed value to cover obligations whose liquidation cost may fluctuate substantially from day to day. Although a properly constructed cash margin system should provide a sufficient cushion to protect the clearing organization against reasonably foreseeable changes in the cost of liquidating members' positions, no workable margin system based on cash or other fixed-value assets can be expected to protect fully against extraordinary price movements. In contrast, where an obligation is fully hedged by a position on the other side of the market, any increase in the cost of liquidating the hedged obligation should be offset by a corresponding increase in the value of the hedge. Concentrating both legs of intermarket hedge positions in a single clearing organization would thus reduce the overall risk to the securities/commodities clearing system in the event of a clearing firm's default.

Cross-margining would also reduce clearing organizations' surveillance problems. A clearing organization attempting to monitor its risk exposure often sees only part of the picture.

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*_See_, _e.g._, 11 U.S.C. §§362(b)(6), 546(e), 548(d)(2)(B), 555, and 556.

A clearing member may be carrying positions in related products with multiple clearing organizations, each unaware -- at least on a moment-to-moment basis -- of the positions carried with the others. While this problem can be partially addressed through better communications among clearing organizations, its scope would be reduced to the extent that clearing firms were given a financial incentive to carry positions in economically similar products with a single clearing organization. The potential cost savings resulting from cross-margining would provide that incentive.

Cross-margining would also eliminate potential settlement problems associated with the maintenance of large intermarket hedge positions. If a firm carries the two legs of an intermarket hedge with different clearing organizations, a sharp price movement in the underlying asset may generate obligations to one clearing organization that cannot be met except out of funds receivable from the other. Even if daily settlements at the two clearing organizations occur simultaneously, which may not always be the case, the time required to transfer funds from one to the other could lead to temporary settlement defaults, possibly affecting a clearing organization's own ability to make timely settlement. If both legs of the hedge could be carried with the same clearing organization, that problem would no longer exist.

In short, cross-margining offers substantial cost and net capital savings to market participants, the potential for greater liquidity and depth in the markets involved, and greater protection for clearing organizations.

Potential Impediments to Cross-Margining

The convergence between the types of products traded in the commodities markets and the securities markets that gives rise to the need and opportunity for cross-margining has taken place within the past few years, and was not contemplated when most of the present CEA was originally enacted. As an unintended result, there are a few provisions in the CEA that, at worst, could be interpreted as preventing the CFTC from permitting cross-margining, or, at best, could create uncertainties if applied in an environment where cross-margining was permitted.* These provisions are found in Section 4d of the CEA, which concerns the segregation of customer funds held by a futures commission merchant, and Section 20 of the CEA, which gives the CFTC authority to include or exclude specified property from "customer property" as defined in the Commodity broker subchapter of the Bankruptcy Code.

In the case of Section 4d, although ICC believes that in its present form that Section allows the CFTC sufficient latitude to adopt rules permitting cross-margining, arguments may be made to the contrary. Accordingly, we are proposing an amendment to that Section that would eliminate the uncertainties that are presented by the existing provisions and would permit the CFTC to deal with cross-margining on its merits, with no question as to its statutory authority to do so. In the case of Section 20, the present provision gives the CFTC authority to determine whether specific property should be included within "customer property" for purposes of the commodity broker subchapter of the Bankruptcy Code. However, since a cross-margined account containing both commodities and securities positions could be subject to both the Bankruptcy Code and the Securities Investor Protection Act of 1970 ("SIPA"), it would seem appropriate that the Securities Investor Protection Corporation ("SIPC") should be given similar authority to allocate property, so that property held in cross-margined accounts would not be subject to conflicting claims under the Bankruptcy Code and SIPA.

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*Although the implementation of cross-margining may require regulatory relief from the Securities and Exchange Commission, the 1934 Act, unlike the CEA, does not appear to contain any potential impediments to cross-margining.

Potential Amendments

Attached to this statement are proposed amendments to Sections 4d and 20 of the CEA that ICC believes would resolve the uncertainties discussed above. The proposed amendments would not mandate cross-margining. Rather, they would eliminate the uncertainties and would leave the CFTC free to specify the terms and conditions under which cross-margining would be permitted.

Although the language of the proposed amendments is somewhat lengthy, the purposes sought to be achieved are simple. The proposed amendment to Section 4d would add a new paragraph expressly permitting funds received by an FCM in connection with customers' commodity transactions to be commingled at the clearinghouse level, subject to such terms as the CFTC might prescribe, with funds received in connection with customers' transactions in SEC-regulated options. The amendment would permit the commingled funds to be used to discharge obligations arising out of customers' transactions in SEC-regulated options as well as in commodity products. Because the clearinghouse would be carrying positions in securities as well as commodity products, the amendment would require a clearinghouse to register as a clearing agency under Section 17A of the 1934 Act as a condition to offering cross-margining.

The proposed amendment to Section 20 of the CEA would avoid overlaps among the various definitions of "customer property" in the Bankruptcy Code and SIPA, as applied to assets in cross-margining accounts, by authorizing the CFTC (together with SIPC, as to cases under its jurisdiction) to adopt rules allocating such assets between securities customer property and commodity customer property. In cases where SIPC did not have jurisdiction, only the CFTC's rules would apply. To avoid potential conflicts in cases where the rules of both the CFTC and SIPC applied, the proposed amendment would require the two organizations to cooperate to ensure that their rules were mutually consistent and became effective simultaneously.

Conclusion

Cross-margining of positions in securities and commodities products relating to the same or similar underlying assets makes eminent good sense from an economic standpoint, and offers significant benefits to both the securities and the commodities markets. Were it not for an accident of history--the separate development of the securities and commodities markets and their regulatory structures -- cross-margining would undoubtedly exist today.

The amendments proposed herein are modest and should be non-controversial. Their only purpose is to eliminate any potential statutory impediments to cross-margining, leaving the CFTC free to evaluate cross-margining on its merits.

Proposed Amendments to Sections 4d and 20 of the Commodity Exchange Act

SEC. ____. Section 4d of the Commodity Exchange Act (7 U.S.C. 6d) is amended by inserting immediately after paragraph (2) thereof the following:

"Notwithstanding the foregoing provisions of this section, money, securities, and property of the customers of a futures commission merchant may, in accordance with such terms as the Commission may prescribe by rule, regulation, or order, be commingled and deposited in an account or accounts maintained with any bank or trust company or with any clearinghouse organization of a contract market that is registered as a clearing agency under the Securities Exchange Act of 1934, with any other money, securities, and property received by such futures commission merchant to margin, guarantee, or secure the trades or contracts of such customers in standardized securities options, or accruing to such customers as a result of such trades or contracts, and such share of the commingled money, securities, and property as in the normal course of business shall be necessary to margin, guarantee, secure, transfer, adjust, or settle the trades or contracts of such customers cleared through such clearinghouse organization (whether in contracts subject to the jurisdiction of the Commission or in standardized securities options), or resulting market positions, may be withdrawn and applied to such purposes, including the payment of any charges lawfully accruing in connection with such trades and contracts. As used in this paragraph, the term 'standardized securities options' shall mean option contracts traded on a national securities exchange or through the facilities of a registered national securities association pursuant to the provisions of the Securities Exchange Act of 1934.".

SEC. ____. Section 20 of the Commodity Exchange Act (7 U.S.C. 24) is amended by --

(1) inserting a new subsection (b) reading as follows:

"(b) Notwithstanding title 11 of the United States Code and the Securities Investor Protection Act of 1970, with respect to any 'debtor' as defined either in title 11 of the United States Code or in the Securities Investor Protection Act of 1970 that is both a commodity broker and a stockbroker, the Commission and SIPC may provide, by rule or regulation, for the allocation, as between 'customer property' as defined in subchapter III of chapter 7 of title 11 of the United States Code, 'customer property' as defined in subchapter IV of said chapter, and 'customer property' as defined in the Securities Investor Protection Act of 1970, of cash, securities, or other property, or proceeds thereof, held by or for the account of the debtor, from or for any account of a customer that includes or included positions both in commodity contracts and in standardized securities options; provided, however, that any rules adopted by SIPC under this subsection shall apply only to debtors as to which SIPC files an application for a protective decree under section 5 of the Securities Investor Protection Act of 1970. In formulating rules or regulations pursuant to this subsection, the Commission and SIPC shall cooperate with each other to ensure that such rules and regulations are mutually consistent and become effective simultaneously."; and

(2) redesignating subsection (b) thereof as subsection (c) thereof and amending that subsection to read as follows:

"(c) As used in this section, the terms 'commodity broker', 'commodity contract', and 'customer' have the meanings assigned such terms for the purposes of subchapter IV of chapter 7 of title 11 of the United States Code; the term 'stockbroker' has the meaning assigned such term for the purposes of title 11 of the United States Code; the term 'SIPC' means the Securities Investor Protection Corporation; and the term 'standardized securities options' has the meaning assigned such term for the purposes of section 4d of this Act. As used in subsection (a) of this section, the terms 'customer property', 'member property', 'net equity', and 'security' have the meanings assigned such terms for the purposes of subchapter IV of chapter 7 of title 11 of the United States Code.

February 24, 1986

The Honorable Jesse Helms
Chairman, Senate Committee on
Agriculture, Nutrition and Forestry
Washington, DC 20510

Re: Statement of London Exchanges re S. 2045 ("The Futures Trading Act of 1986")

Dear Sirs:

On behalf of the London Commodity Exchange, the London Metal Exchange, the London International Financial Futures Exchange, the Grain and Feed Trade Association and the International Commodities Clearing House, ("the Exchanges") I enclose a Statement relative to S. 2045. It would be very much appreciated if the Statement could be included in the printed Record of Hearings on S. 2045.

As the Committee is aware, the Exchanges play a vital role in world commerce and finance. In this context, among other issues discussed, the Statement notes concerns about Section 102 of S. 2045 (authorizing extraterritorial service of CFTC administrative subpoenas).

The concern of the Exchanges respecting Section 102 is also shared by the British Government. Recent discussions between the two nations have made progress toward de-escalating tensions arising from extraterritorial U.S. demands on UK residents. The Exchanges accordingly hope the amendment will not be adopted.

The Statement also notes that Section 101 of the Bill creates a question respecting application of Section 4b of existing law to transactions which take place on foreign exchanges. These transactions are already addressed by another Section of the Act, Section 4(b), and Section 101 should be restated so as to limit its application solely to transactions on, or under U.S. law required to be on, U.S. exchanges.

We hope that the Committee will be able to favorably address these problems. I would be glad to discuss these matters with you or your staff at any time.

Best wishes,

John V. Rainbolt

Attachment

This letter and the attached Statement is being submitted by John V. Rainbolt, Miles & Stockbridge, 1701 Pennsylvania Avenue, N.W., Suite 500, Washington, D.C. 20006, on behalf of the London Commodity Exchange Company Limited, the Metal Market and Exchange Company Limited, the London International Financial Futures Exchange Limited, the Grain and Feed Trade Association, and the companies are foreign organizations, the writer is required to register with the Department of Justice under the provisions of 22 U.S.C. Sec. 611, *et seq.*, as their agent. Copies of this letter and its attachment are being filed with the Department of Justice and copies of the appropriate registration statement will be available for public inspection at the Department of Justice. Registration does not indicate approval of this material by the United States Government.

STATEMENTS OF THE LONDON COMMODITY EXCHANGE COMPANY LIMITED, THE METAL MARKET AND EXCHANGE COMPANY LIMITED, THE LONDON INTERNATIONAL FINANCIAL FUTURES EXCHANGE LIMITED, THE GRAIN AND FEED TRADE ASSOCIATION, AND INTERNATIONAL COMMODITIES CLEARING HOUSE LIMITED

STATEMENT OF FOUR LONDON COMMODITY EXCHANGES AND THE INTERNATIONAL COMMODITIES CLEARING HOUSE LIMITED, RELATIVE TO S. 2045 ("FUTURES TRADING ACT OF 1986")

I. Introduction

The following-named British organisations (collectively, "The Exchanges")[1] take this opportunity to provide their views on S. 2045 ("to amend the Commodity Exchange Act to reauthorise appropriations to carry out such Act, and for other purposes") introduced by Senators Helms and Lugar (by request):

A. The London Commodity Exchange Company Limited

The London Commodity Exchange Company Limited ("LCE") represents the interests of its member Associations, which are:

- (i) The London Sugar futures Market Limited (formerly the United Terminal Sugar Market Association Limited;
- (ii) The Coffee Terminal Market Association of London Limited;
- (iii) The London Cocoa Terminal Market Association Limited;
- (iv) The London Rubber Terminal Market Association Limited; and
- (v) The International Petroleum Exchange of London Limited.

These LCE Associations operate the London futures markets for sugar, coffee, cocoa, rubber and petroleum products. The membership of the LCE Associations includes a large number of companies established in many different parts of the world involved in worldwide trading in commodities. Many are U.S. futures commission merchants ("FCMs") who accept orders in the United States for futures transactions on the LCE.

LCE's markets have a long history of stable and successful trading and self-regulation. LCE contracts are cleared and guaranteed by the International Commodities Clearing House Limited ("ICCH"). The Bank of England maintains a general surveillance of the London futures markets and of the regulatory system administered by LCE's Associations. LCE enjoys a high international reputation and has operated for many years.

B. The Metal Market and Exchange Company Limited (The London Metal Exchange)

The London Metal Exchange ("LME") has been in existence for well over 100 years. It is the world's most comprehensive metal market and handles the trading of seven metals--cooper, tin[2], lead, zinc, silver, aluminium and nickel.

LME trades on a principal-to-principal basis among its members. It is regulated internally by a committee annually elected by the membership. The Bank of England exercises surveillance over the general conduct of the Exchange.

LME is an international market. More than three-quarters of its ring-dealing companies are affiliates of non-UK firms, many of which are U.S. corporations. The Exchange's official daily metal prices are disseminated worldwide and form a basis for contractual prices between producers and consumers for most of the metals traded throughout the Western world outside the dollar areas, as well as in the Eastern bloc.

C. The London International Financial Futures Exchange Limited

The London International Financial Futures Exchange Limited ("LIFFE") is an independent London exchange which commenced operations in 1982. LIFFE provides facilities for trading in futures and options contracts covering interest rates, currencies, and the FT-SE (Financial Times-Stock Exchange) 100 Index. LIFFE's contracts are cleared and guaranteed by ICCH. LIFFE was established with the concurrence of the Bank of England, which exercises surveillance over the general conduct of the Exchange. The primary supervision of the Exchange and its members is the responsibility of the Board of the Exchange. Many of the members of LIFFE are prominent U.S. banks and brokers.

D. The Grain and Feed Trade Association

The Grain and Feed Trade Association ("GAFTA") was established in 1971 as an amalgamation of two organizations which had operated in the physical grain trade for nearly 100 years. GAFTA has an international reputation in the grain world, providing standard form physical grain contacts and arbitration facilities for those involved in the grain trade worldwide. It owns and administers the London Grain Futures Market which was established in 1929 and the clearing house which clears the wheat and barley contracts traded on that market.

It provides the secretarial services for the following markets, which it also represents in this Statement:

(i) The GAFTA Soya Bean Meal Futures Association Limited;
(ii) The London Potato Futures Association Limited;
(iii) The London Meat Futures Exchange Limited.

Soya bean meal, potato and meat contracts are traded on these markets, which are situated in the Baltic Exchange in London. The contracts are cleared by ICCH. These markets, including the London Grain Futures Market, have many members involved in worldwide trading in commodities. Many of the brokers and dealers who are members of these markets are U.S. FCMs.

E. The International Clearing House Limited

The International Commodities Clearing House Limited ("ICCH") which was established in 1888 is an independent body owned by the major UK banks which clears and guarantees futures and options contracts in accordance with the rules of the Exchanges. It also clears and guarantees contracts traded on a number of other Exchanges world-wide.

The ICCH operates a comprehensive system of daily initial and variation margin clearing.

II. The United Kingdom Regulatory Structure for Futures Markets

The Exchanges provide a forum for risk-shifting and price discovery, utilized by diverse international interests. Each market is subject to the surveillance of The Bank of England and English legal principles govern dealings, with United Kingdom and foreign customers. The efficacy of this regime has been such that to the Exchanges' knowledge, conduct and standards associated with the British markets have never been a source of regulatory concern in the United States.

Largely in response to developments respecting financial markets generally, the Financial Services Bill ("the Bill") now before Parliament (expected to come into effect in 1987) will result in substantial enhancement of the customer protection features presently found in British law.

Under the Bill as drafted The Securities and Investments Board ("SIB") will administer customer protection standards established by the Act and delegated to SIB by the Secretary of State for Trade and Industry. As with the U.S. system of regulation, the principal enforcement mechanisms for the new law will be lodged with self-regulating organizations. The Exchanges have supported the recent establishment of a new independent self-regulatory organization. The Association of Futures Brokers and Dealers ("AFBD") to assist in developing and enforcing customer protection values. In certain respects. AFBD occupies a role similar to that of National Futures Association in the U.S. Acting under SIB oversight, AFBD and the Exchanges will promulgate and enforce standards governing dealings between brokers or dealers and customers (including public customers). These standards will relate to capital requirements, disclosure rules, "know your customer" requirements, and protection of customer accounts. These standards, invoking such rules as a "cooling off" requirement for public customers, a ban on unsolicited "cold calls" on public customers and the establishment of a compensation fund for public customers may well exceed counterpart U.S. rules.

From the perspective of this Statement, perhaps the most import aspect of the proposed United Kingdom regulatory regime is that the standards mentioned will govern the activities of both brokers of dealers of any nationality or residents doing futures or options business in the United Kingdom, whether with U.K. or U.S. or other foreign customers and whether on London markets or elsewhere.

III. General Exchange Concerns Relative to U.S. Regulation of the International Marketplace

Unrestricted access to United Kingdom markets by U.S. traders and to U.S. markets by United Kingdom trader enhances market efficiency, resulting in a better forum for price discovery and risk-shifting at each locale, eventually benefitting the global economy. In their dealings with foreign governments, the Exchanges have endeavoured to support an equilibrium between foreign and U.K. markets so that the benefits of free markets will be present at both. Nowhere is the maintenance of this equilibrium more important than the relationship involving United States and United Kingdom markets.

Some past activities of the Commission have threatened that equilibrium. One particular example is the CFTC's continuing ban on the offer and ale of foreign options to U.S. public customers. The Exchanges and the British Government have repeatedly expressed their concern about the ban. The Exchanges take this occasion to again express their objection to continuation of the ban in any form. The Exchanges will continue to work to remove the ban with hope for early favourable development.

A second area of concern related to the implementation of Section 4(b) of the Commodity Exchange Act which authorizes the CFTC to develop rules and regulations governing the activities of U.S. vendors handling U.S. customer accounts for futures contracts traded on foreign exchanges. The Exchanges' view is that the Commission must be very cautious in exercising its powers under 4(b) to avoid a damaging extraterritorial effect.

A third area of major concern involves CFTC reporting requirements applicable to positions carried by British nationals on United States markets. The Exchanges do not object generally to the concept that when trading in United States markets one must trade by United States rules, as this principle is equally applicable to dealings on British markets. However, the Exchanges continue to be concerned about the exposure of their member firms to CFTC enforcement activities related to extraterritorial demands for information not within the Commission's purview.

IV. The Specific Concerns of the Exchanges Respecting Sections 101 and 102 of S. 2045

From the foregoing it will be apparent that the Exchanges believe the U.S. government should ensure that attempts to enforce U.S. law outside the territorial boundaries of the United States do not erect unnecessary barriers to international markets, and in particular to United Kingdom markets. Any barriers, whether through enforcement of extraterritorial information demands or otherwise are to be deplored.

In the latter connection, the Exchanges are respectful of the many domestic political and regulatory issues that govern Congressional decisions respecting S. 2045 and related legislation. As the same time, the Exchanges call to the attention of the Committees their very strong concerns respecting two provisions of S. 2045.[3]

The primary concern of the Exchanges relates to Section 102 which proposes to amend the Commodity Exchange Act to authorize the CFTC to enforce its investigative subpoenas upon foreign nationals served in a foreign nation. The Commission apparently feels the proposed authority is a somewhat routine response to a 1984 U.S. Court of Appeals decision (CFTC v. NAHAS)[4] which invalidated enforcement of a CFTC administrative subpoena served in Brazil upon a citizen of Brazil. The Exchanges respectfully point out that the proposed amendment is farm from routine from the British perspective and raises wider questions of conformity with principles of international law.

Much of the Exchanges' concern can be derived by a review of the opinion which spawns the amendment. In that opinion, the Court of Appeals made it clear that to construe the law as authorizing the district court to enforce an investigative subpoena served on a foreign citizen in a foreign nation,

> ". . . would seriously impinge on principles of international law. When compulsory process is served (on a foreign citizen on foreign soil in the form of an investigative subpoena) . . . the act of service itself constitutes an exercise of one nation's sovereignty within the territory of another's sovereign. Such an exercise (absent consent of the foreign nation) constitutes a violation of international law."[5]

In considering Section 102 we hope the Committee will recognize that the court in NAHAS was reluctant to uphold a reading of the existing Act to infer CFTC jurisdiction, since to do so would seriously impact on principles of international law.[6]

The Exchanges also wish to point out the particular sensitivity attached to the proposed amendment in the United Kingdom, where exercise of powers similar to those involved in Section 102 was a catalyst to enactment by British Parliament of U.K. defensive legislation "The Protection of Trading Interests Act of 1980" authorizing Her Majesty's Government to issue a protective order where the national interest is involved, to a British concern or citizen confronted with a foreign investigating subpoena demanding production of information or attendance of a witness.

The need for respect for international comity is recognized in both jurisdictions. There is an alternative to enactment of Section 102. The Exchanges understand that discussions between the British Government and U.S. Regulators including the CFTC on the general topic of information sharing are expected momentarily. The prospect of co-operation would seem the preferred route leading to information sharing between the two governments, thereby anticipating and minimising the tensions that are likely accompany adoption of such a unilateral action as the suggested amendment.

The Exchanges also have a concern respecting the application of Section 101 of the legislation to contracts traded on London Exchanges. Read literally, Section 101 (through its deletion of references to contracts traded only on U.S. contract markets) could be read as an inadvertent extension of section 4b beyond its role as an anti-fraud provision governing only US contracts, to also cover foreign futures contracts. These latter contracts are now regulated under rules adopted under section 4(b) of the Act and Regulation 30.02 of current law. Accordingly, the language of the proposed amendment, should it be enacted, should be restated so as to clarify that its application is only to transactions which are on, or under U.S. law required to be on U.S. contract markets.

V. Conclusion

For the foregoing reasons, the Exchanges respectfully recommend that Congress

(1) not enact Section 102, or, in the alternative, exempt British firms and customers from the effect of the proposal, and

(2) clarify Section 101 so that the proposed amendment cannot be read as applied to futures and options made, or to be made, on or subject to the rules of the Exchanges.

The Exchanges appreciate this opportunity to express their views respecting S. 2045, and their concerns regarding CFTC regulation. The Exchangers have appreciate the attitudes and remain grateful for courtesies displayed by individuals at the Commission and its staff and look forward to continuing to work directly with them on matters of mutual importance.

FOOTNOTES FOR FOUR LONDON COMMODITY EXCHANGES AND THE INTERNATIONAL COMMODITIES CLEARING HOUSE LIMITED

[1] These *collective* views of the captioned markets are subject to appropriate supplement by separate views of an individual Exchange. The participation of the Exchanges in this Response should not be interpreted as agreement to U.S. jurisdiction, in any form, respecting dealings with U.S. customers by members of any of the Exchanges. Market contracts are entered into and discharged not in the United States but in London.

[2] Tin trading was temporarily suspended effective 24 October 1985.

[3] Whilst attention is drawn at this stage to issues arising out of Sections 101 and 102, the Exchanges are giving consideration to other aspects of S. 2045 in which further comments may be forthcoming.

[4] CFTC v NAHAS CCH Com. Fut. L. Rep., Paragraph 22, 247.

[5] *NAHAS* supra p. 29, 278.

[6] *NAHAS* is fairly precise example of the type of exercise of extraterritorial jurisdiction which is a particular source of concern to the Exchanges and their membership. In *NAHAS*, the action was characterized by the Court of Appeals as being intrusive and offensive to Brazilian sovereignty. *NAHAS* n. 16.
In so doing, the CFTC had also ignored guidance by the court concerning methods of extraterritorial service that would minimize intrusion on another nation's sovereignty. *Id*. n. 15.

The London Commodity
Exchange Company Limited

The London International
Financial Futures
Exchanges Limited

The Metal Market and
Exchange Company Limited

The Grain and Feed Trade
Association

International Commodities
Clearing House Limited

DATED 21st February 1986

LONDON

SUPPLEMENTAL STATEMENT OF THE LONDON COMMODITY EXCHANGE COMPANY LIMITED, THE METAL MARKET AND EXCHANGE COMPANY LIMITED, THE LONDON INTERNATIONAL FINANCIAL FUTURES EXCHANGE LIMITED, THE GRAIN AND FEED TRADE ASSOCIATION, AND THE INTERNATIONAL COMMODITIES CLEARING HOUSE LIMITED

I. Introduction

This Statement supplements the Statement dates 21st February 1986 (previously submitted) made by the British organisations listed below (collectively, "the Exchanges")[1] relating to S. 2045 ("to amend the Commodity Exchange Act to reauthorise appropriations to carry out such Act, and for other purposes") introduced by Senators Helms and Lugar (by request).

The Exchanges[2] whose views are represented in this supplemental Statement are:

1. The London Commodity Exchange Company Limited
2. The Metal Market and Exchange Company Limited
3. The London International Financial Futures Exchange Limited
4. The Grain and Feed Trade Association
5. International Commodities Clearing House Limited

Some of the general concerns of the Exchanges relating to U.S. regulation as it affects the Exchanges and their members were expressed in their 21st February 1986 Statement, together with their specific concerns relating to Sections 101 and 102 of S.2045. In this supplemental Statement, the Exchanges provide their views on Section 103 of S.2045 an on a proposal which they understand to have been put forward by the North American Securities Administrators Association.

II. Section 103 of S.2045

Section 103 of S.2045 proposes the enactment of a new Section 24 of the Commodity Exchange Act, which provides that (except as otherwise expressly provided in the Act) judicial review of a final order or rule of the Commodity Futures Trading Commission may be obtained only in the United States Court of Appeals for the Circuit in which the person seeking review resides or has its principal place of business. By its terms, this provision fails to provide any possibility of judicial review to foreign persons or entities which neither reside nor have their principal place of business in the United States.

The CFTC purports to regulate foreign persons and entities which enter into transactions on U.S. futures exchanges even though they do not reside or have a place of business in the United States. Indeed, the CFTC has brought a number of enforcement actions against such foreign entities. *See, e.g., In re Allan J. Ridge & Co.*, CCC Commodity Futures L. Rep. para. 21,819 (1983); *In re Banque Populaire Suisse*, CCH Commodity Futures L. Rep. para. 21255 (1981): *In re Wiscope S.A.*, CCC Commodity Futures L. Rep. para. 20,785 (1979), *rev'd*, 604 F.2d 764 (2d Cir. 1979). The anomalous effect of the proposed provision would be that the CFTC could initiate and prosecute an enforcement proceeding against such a foreign entity which would then have no ability to obtain judicial review of the Commission's final order in the case against it.

Furthermore, the CFTC has in the past adopted a number of rules which impact on foreign traders as well as on domestic entities and indeed in some instances has adopted rules which have a special impact on such foreign entities. *See, e.g.*, 17 C.F.R. sec. 17.02(b) (reports filed by foreign brokers). Yet under the proposed Section

24, such foreign entities would have no opportunity to obtain judicial review of a similar new rule.

The Exchanges do not comment on the propriety of the proposed method of judicial review contained in Section 24, since such an issue is clearly one of U.S. administrative procedure. However, the Exchanges do feel that any provisions adopted by Congress for judicial review of final orders and rules adopted by the CFTC should permit foreign persons and entities equal access to the United States courts with U.S. persons and entities. The United States should not seek to impose its laws on foreigners without permitting them recourse to its courts. Furthermore, it should not treat U.S. entities more favourably in this regard than foreign entities. To bar interest foreign entities from access to the U.S. courts for review of CFTC actions would raise serious questions under the Fifth Amendment Due Process Clause of the U.S. Constitution.

III. North American Securities Administrators Association's Proposal

The Exchanges understand that the North American Securities Administrators Association has urged that Section 12(e) of the Commodity Exchange Act should be amended so as to permit state authorities to regulate transactions in foreign options. The Commodity Exchange Act currently provides that the CFTC has exclusive jurisdiction to regulate options transactions. The uniformity of regulation guaranteed by this provision is extremely important and would be eliminated by the proposal of the NASAA.

The CFTC is currently considering the termination of its pilot program in options. This development will usher in a new regulatory regime covering options traded on U.S. exchanges. Furthermore, the Exchanges have urged the CFTC to consider authorizing trading in foreign options. The CFTC has the expertise, the factual background, and the regulatory powers to devise and to enforce appropriate regulations permitting the offer and sale of foreign options. This uniform approach is far preferable to allowing fifty states to adopt and to enforce inconsistent, vague, and contradictory regulations which would in effect act as an unnecessary bar to trading foreign options in the U.S. The Exchanges recommend that the NASSA proposal should not be adopted.

IV. Conclusion

For the foregoing reasons, the Exchanges respectfully recommend that Congress--

(1) amend section 103 to permit foreign persons and entities equal access to the United States courts with U.S. persons and entities, and

(2) not adopt the NASAA proposal that state authorities be permitted to regulate transactions in foreign options.

The Exchanges appreciate this opportunity to express additional views on S.2045 and related matters.

FOOTNOTES FOR SUPPLEMENTAL STATEMENT OF LONDON COMMODITY EXCHANGE, METAL MARKET AND EXCHANGE, LONDON INTERNATIONAL FINANCIAL FUTURES EXCHANGE, GRAIN AND FEED TRADE, AND INTERNATIONAL COMMODITIES CLEARING HOUSE LIMITED

1/ These collective views of the Exchanges are subject to appropriate supplement by separate views of an individual Exchange. The participation of the Exchanges in this Response should not be interpreted as agreement to U.S. jurisdiction, in any form, respecting dealings with U.S. customers by members of any of the Exchanges. Market contracts are entered into and discharged not in the United States but in London.

2/ For a fuller description of each of the Exchanges, please refer to the 21st February 1986 Statement by the Exchanges.

United States Department of State
Washington, DC 20520

Dear Mr. Chairman:

At the request of the British Government, we are forwarding to you the enclosed note concerning S.2045. In transmitting this note, the Department of State is not expressing a position on the proposed legislation.

Sincerely yours,

James W. Dyer
Acting Assistant Secretary
Legislative and Intergovernmental Affairs

Enclosure

The Honorable Jesse Helms
Chairman, Committee on Agriculture,
Nutrition, and Forestry

NOTE NO. 29

Her Britannic Majesty's Embassy present their compliments to the Department of State and have the honour to draw attention to H.M. Government's concern about the Commodity Futures Trading Commission's proposed redrafting of Section 6(B) of the Commodity Exchange Act (7 USC 15) in S.2045. This proposal purports to permit the extraterritorial serving of subpoenas to require attendance at hearings or to produce records located outside the United States.

As the Department of State and the Commission are aware, Her Majesty's Government have on a number of previous occasions made representations about the provision to the Commission of information located outside the United States and pointed to the need for US agencies to consult their counterpart UK authorities and seek agreement to the carrying out of enforcement activities within the UK. The United States Government will be aware of the reasons which led the United Kingdom to enact the Protection of Trading Interests Act 1980 as a purely defensive measure.

Her Majesty's Government believe that it would be particularly regrettable for Congress to enact legislation of this kind at a time when the UK and US regulatory authorities (including the CFTC) are now exploring the possibilities of reaching understandings on the mutual exchange of regulatory information, and when the detailed information requirements relating to proposed links between UK and US exchanges are under review.

Her Britannic Majesty's Embassy avail themselves of this opportunity to renew to the Department of State the assurance of their highest consideration.

BRITISH EMBASSY
20 February 1986

STATEMENT OF ROBERT A. DENMAN, LEGISLATIVE ASSISTANT
NATIONAL FARMERS UNION, WASHINGTON, DC

The National Farmers Union, a general farm organization representing the interests of 300,000 American farm and ranch families, has long acknowledged the need to have a strong federal agency to watch over trading on the nation's futures exchanges to protect the public, and the markets themselves, from the occurrence of abusive trading practices or efforts to manipulate the markets. It was for that reason the Farmers Union supported legislation creating the Commodity Futures Trading Commission and today strongly urges you to reauthorize the CFTC for another six years.

The CFTC can fulfill its mandate as a watchdog agency, however, only if it has the ability to reconstruct trading patterns on the exchanges in order to determine whether the markets have been manipulated or whether certain of its participants have been engaging in abusive trading practices. In that regard, the Farmers Union has been heartened by the Commission's audit trail rule which would require the reconstruction of trading to the nearest minute and by recent technological advances which make that rule now appear feasible through one or more of approaches that are available to the futures exchanges.

At this time, it appears that both the Commission and the exchanges are making progress in getting audit trail systems installed in the near future and we trust that they will be allowed to proceed with that process without interruption. The Farmers Union believes the implementation of the audit trail rule by the Commission and the exchanges will be a big step forward in providing greater protection to the public at large, and the exchanges themselves, by reassuring a sometimes skeptical public that trading abuses can be spotted and corrected.

We thank you in advance for your consideration of our views.

STATEMENT OF CARL F. SCHWENSEN, EXECUTIVE VICE PRESIDENT
NATIONAL ASSOCIATION OF WHEAT GROWERS, WASHINGTON, DC

The National Association of Wheat Growers has been very much interested in the advances made by futures exchanges in tracking floor trades as a means of ensuring that traders are complying with exchange rules. The "audit trail" issue is an important one for producers, because the ability of exchanges, as well as the CFTC, to enforce trading rules is essential in maintaining the integrity of futures markets. And a responsive futures market is a vital element in the pricing and marketing of commodities.

The exchanges and the CFTC have been meeting to attempt to agree on the manner in which trades can be recorded so that an accurate and verifiable time can be assigned to such trades, including trades made between one floor trader and another. Hopefully, such discussions will lead to some agreement on how the recent CFTC proposed rule requiring trade reconstruction to the nearest minute can be implemented using the electronic systems now in place in some exchanges.

Reportedly, progress is being made, but complete resolution of the outstanding issues will require time. This had been assumed by the commission in establishing compliance timetables for its proposed rule. Final compliance will not be required until next October.

In the meantime, we would hope that the committee will plan to go forward with reauthorization of the commission. Delays in reauthorizing the commission's programs will only create uncertainty, while a good adaptation, will be able to meet the criteria set forth in the commission's proposed rule.

Thank you for your consideration of our views.

STATEMENT OF CHARLES L. FRAZIER, DIRECTOR NATIONAL FARMERS ORGANIZATION, WASHINGTON, DC

The National Farmers Organization does not trade on the futures markets, but many of our members do use the exchanges to hedge their commodity sales. We were active on legislation establishing the Commodity Futures Trading Commission and have maintained a working relationship there in recent years. The efforts of the Commission members and staff have served very well in re-establishing some public confidence in these markets.

The Commission proposed a new rule in January that gives each exchange adequate time to perfect a new system that will more accurately record the timing of trades. This proposed new audit trail is of vital importance when it is necessary to investigate alleged manipulation or discover whether dual traders are acting for their own accounts at the expense of clients they are supposed to represent. Under current rules trades must be recorded only by half-hour periods.

The proposal does not specify a particular method for each exchange. It wisely calls for each to develop its own procedure and establishes a time table extending over one year for each system to be proposed, approved and demonstrated in actual practice.

The Commission has shown good faith by offering to consider alternative methods proposed by the Chicago exchanges. They have consulted and continue to consider those additional ideas developed in the industry. However, there are many important questions of substance yet to be resolved.

For example, the system implemented in each exchange should produce a record that can be proven to be accurate. It should include data on all trades, including those made between floor traders.

My purpose in writing to you is to suggest that the Congress take a lesson from its recent difficulties in trying to write detailed procedures into a farm bill. It is not possible to venture into such bureacratic endeavors in legislation without making expensive errors and detracting from the significant value of the authorizing legislation.

It is suggested that you extend the authority of this Commission for six years and permit it to carry out its regulatory responsibilities. After all, the agency was created because existing authorities in the Congress, the Courts and the Executive Branch found it impossible to police adequately the conduct of futures contract trading in the many commodities involved.

We appreciate your interest. Please be in touch if we may be helpful.

STATEMENT OF DEAN KLECKNER, PRESIDENT
AMERICAN FARM BUREAU FEDERATION, PARK RIDGE, ILLINOIS

The American Farm Bureau Federation requests that the Commodity Futures Trading Commission be reauthorized by Congress.

The CFTC has performed commendably during the past four years and has earned the respect of Farm Bureau members and leaders. Lack of reauthorization would cause unnecessary disruption in the orderly regulation and control of the commodity exchanges offering futures and option contracts on agricultural commodities. It would erode producers' and processors' faith and trust in the market system at a time when their need is growing for futures and options as a risk-transfer marketing tool.

The AFBF also support the following changes or amendments to the original act:

1. Clarification that the Act prohibit fraud in connection with any transaction, regardless of where it is executed (as opposed to present limitation of execution on a contract market). This will permit the Commission to pursue off-exchange operators.
2. Authorize serving investigatory subpoenas on persons outside the territorial United States. This authority would parallel that already existing for other agencies.
3. Provide uniform treatment for all final Commission action by limiting review of persons aggrieved by final Commission order to the Court of Appeals.
4. Authorize the Commission to seek appointment of a temporary exparte receiver when an exparte freeze has been issued--to protect or help preserve assets for investors while the court proceeds with appointment of a permanent receiver.
5. Eliminate leverage regulation. This will require leverage transaction merchants to modify their product line to deal in exchange-trade futures, or offer cash or installment sale commodities under applicable regulations of the states.
6. Broaden the Commission's authority to review and alter rules generated by the NFA to parallel the present authority over the rules that contract markets establish to govern such areas as sales practices and financial requirements of their members.
7. Simplify and clarify procedures for review of disciplinary actions brought by the NFA--to make NFA actions parallel the actions of exchanges--where a stay may be granted but is not a matter of right.
8. Authorize the Commission to review the record of proceedings before the NFA, regarding denial of membership, without having to hear or consider new evidence. This would be similar to the standards governing FFA disciplinary actions.
9. Permit Commission employees to invest in actual commodities (hedge) so long as no nonpublic information is used and the transactions do not involve commodity futures or options, and to empower the Commission to permit other transactions by rule.

The American Farm Bureau Federation also has supported the CFTC in its ruling regarding the audit trail requirements of the exchanges so that futures and options trades will be recorded by time of sale, to the nearest minute, and in actual sequence of trades. We consider this as a necessary condition for not only improving the CFTC's ability to properly function as a regulatory agency, but also to improve the integrity of the futures and options markets.

STATEMENT OF ROY G. WILKEN
PARADISE FARMS, INC., DANFORTH, ILLINOIS

Mr. Chairman, when you first look at the Commodity Futures Trading Commission's official seal with its eagle perched on top of a plow and gear holding a balance scale in it's mouth you are lead to believe that the CFTC is a branch of the U.S. government that provides justice in the marketplace equally to agriculture and industry. When in fact nothing could be further from the truth. Since it's inception the Commodity Futures Trading Commission has been a total disaster for American agriculture. In fact whenever the Commission has been forced to make a decision between the often conflicting interests of agriculture and the grain trade or the futures industry, agriculture always loses.

In August 1984 the then president of the Chicago Mercantile Exchange, Mr. Clayton Yeutter, told a reporter from the Wall Street Journal that the incoming Reagan administration had sought help in selecting a new chairman for the CFTC "in fact the exchanges took the initiative" in selecting all five members of the commission, including the current chairman Ms. Susan Phillips. I remember thinking with all the members of the CFTC being hand picked by the futures industry, I certainly hope they are going to be fair. But alas it was not to be.

The Commodity Futures Trading Commission has repeatedly refused to address the outrageous flaws in our corrupt marketing system; flaws that allow the markets to be manipulated by large commodity buyers using large short futures trades to hammer down cash commodity prices, which they can then buy at a lower price. Before Congressional hearings held in 1984, CFTC commissioner, Fowler West and Vice Chairman of the Chicago Board of Trade, Neal Kottke, admitted that commodity markets could be manipulated in that way. You can be sure if someone was stealing from the futures industry or the grain trade the CFTC would have done something about it by now.

The Commodity Futures Trading Commission refuses to even look into regulating speculative short trading which is the major flaw in the futures market. The short speculator sells a commodity he doesn't own and can't produce hoping to profit by buying it back at a future date at a lower price. The short speculator really doesn't have a legitimate economic interest in the commodity because he doesn't have a cost to protect. The short speculator's sales compete with the commodity producers hedge sales and the cash commodity buyers hedge sales for the buyers that are in the market and thereby increases the apparent supply of the commodity and therefore reduces the commodity futures price. Because the cash commodity price closely follows the commodity futures price, the short speculator steals from every commodity producer. In fact holding a short speculative position is a form of stealing. This is why the futures market can continue to go down even though producers are not selling because the price is below the cost of production.

Before the tragic stock market crash in 1929, trading rules allowed speculative short trading. These rules were very similar to the unfair speculative short trading rules that farmers are forced to live with now on the commodity futures markets. After the crash Congress set up the Securities Exchange Commission (SEC). Because uncontrolled speculative short trading may have played a large roll in the stock market crash, and because it was perceived that securities that are traded in a market that allowed speculative short trading tended to be priced lower, trading rules were changed, and now speculative short trading on the stock market is very strictly regulated. Today a speculator can sell stock he doesn't own, only if he first borrows it from someone who does, and only if the market is going up. As a farmer I wonder why the same reforms weren't extended to the commodity futures markets?

It is true that recently The Commodity Futures Trading Commission has put forth a number of proposals including the new 1-minute recording rule that if enacted would be very beneficial to the commodity producers at the expense of the futures industry for a change. I think these are just a smoke screen to reduce producer objections at the CFTC's reauthorization hearings. After hearing all the crying about the new 1-minute recording rule from the futures industry, it is my guess that if CFTC is reauthorized they will quietly drop it.

Please Please do not reauthorize The Commodity Futures Trading Commission!! I don't think American agriculture can stand another four years of their pseudo regulation. As far as I am concerned the CFTC is a major part of the farm problem and a ideal place to save federal tax money. Please give the responsibility for regulating the futures markets to the Securities Exchange Commission (SEC). You can be sure they understand the dangers of unregulated speculative short trading.

STATEMENT OF L. R. GAJEWSKI
ALEXANDER, NORTH DAKOTA

As a part of the authorization, the agency should be required to limit speculative short sales to the amount of any particular commodity held or controlled by the seller, and then only on an uptick (as is the case with common stocks).

It is axiomatic that at any point in time the existing short open interest serves to depress the market when the holders of the physical commodity in question can least afford the downward pressure.

A good case in point is the present demoralized crude oil market, where one oil man made the point in the WSJ that a New York dentist (shorting the crude market) has more control over the price than he does. Significantly the crude market is in disastrous slide when less than one percent (1%) of the futures contracts being sold are being delivered. If 99% were being delivered, futures would then serve as a legitimate "price discovery" tool. As things stand now, oil futures are an even greater disaster than other commodities on the CBT where about 7% of the contracts are delivered.

Regardless of how it is accomplished, both future sales and option puts MUST be limited to the amount held or controlled by the seller. Do this and we will have a legitimate supply and demand market instead of the gamblers farce that now exists.

STATEMENT OF NEAL P. GILLEN, VICE PRESIDENT AND GENERAL COUNSEL AMERICAN COTTON SHIPPERS ASSOCIATION, WASHINGTON, DC

ACSA support the reauthorization of the Commodity Futures Trading Commission as an independent regulatory agency.

Cotton Merchants have the dual functions of buying and selling cotton, including the assumption of the time, quality and price risks requiring a viable futures market properly supervised by a government regulatory entity. Since its establishment by Congress in 1975, the Commission has, in the opinion of our members, developed the proper regulatory emphasis which assures the public, the producer and the commercials a healthy trading environment.

The only concern we have with the Commission is the persistence of some staff members to interfere with the functioning of contract markets, such as suggesting additional delivery points, which in our opinion are not necessary for cotton.

STATEMENT OF THE PRUDENTIAL INSURANCE COMPANY OF AMERICA, METROPOLITAN LIFE INSURANCE COMPANY, AND THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES

Mr. Chairman and Members of the Committee, this statement is submitted on behalf of The Prudential Insurance Company of America, Metropolitan Life Insurance Company, and The Equitable Life Assurance Society of the United States. As three of the country's largest life insurance companies, we have been in the investment management business for many years. In addition to managing our own general corporate assets, we provide investment management to pension plans, mutual funds, foundations, endowments, separate accounts that fund life insurance and annuity products, and others. Our combined assets total over $225 billion, and we provide investment management and advice, either directly or through our subsidiaries, to portfolios whose total value is in excess of $180 billion.

As investment managers, we are already regulated in several capacities, including, most importantly, as registered investment advisers under the Investment Advisers Act of 1940, and also as ERISA fiduciaries in our management of pension plan assets. Within the last few years, institutional investment managers such as insurance companies have begun to utilize financial futures contracts and related options as aids in the management of their clients' securities portfolios. This has led to a potential for duplicative, unnecessary and ill-suited regulation under the Commodity Exchange Act.

In the Futures Trading Act of 1982, Congress clarified many important issues regarding the respective jurisdictions of the CFTC and the SEC in light of the advent of financial futures contracts. But two important and related issues were not expressly resolved by that legislation--namely, that managers of securities portfolios who are already subject to appropriate regulation by the SEC might become subject to unnecessary and ill-suited regulation as, first, commodity pool operators ("CPOs") or as, second, commodity trading advisors ("CTAs"), simply because they employ financial futures in connection with the management of securities portfolios. One of these issues--the CPO issue--was addressed last year by the CFTC through its adoption of Rule 4.5, which excludes certain otherwise regulated entities from the definition of a CPO when they use futures in limited ways. This rule--which was prompted by a statement in the

Senate Agriculture Committee's Report on the Futures Trading Act of 1982 that such exemptions would be appropriate--has been quite helpful, although there is a need to broaden certain of its provisions. But the second and closely related issue of whether otherwise regulated entities that provide securities advice and management should be subject to regulation as CTAs if they use financial futures as a tool in the management of securities portfolios has not been addressed by the Commission. And the issue has become a critical one for insurance companies and other institutional investment managers. It is our view that subjecting such already-regulated advisors to further registration and regulation as CTAs (1) serves no valid purpose, (2) imposes inappropriate burdens on such advisors, and (3) puts such advisors at an unjustifiable competitive disadvantage as compared to banks and trust companies, which are expressly excluded from the Commodity Exchange Act's definition of a CTA.

I. The Use of Financial Futures by Managers of Securities Portfolios

Financial futures and related options are extremely useful tools that help professional money managers--insurance companies, investment advisers, banks, trust companies, etc.--deal with the risks of today's volatile and unpredictable capital markets. Use of futures can provide significant advantages in the management of a securities portfolio. It must be borne in mind, however, that such advisors are engaged in managing securities portfolios, and hence their primary business as registered investment advisers involves investments in securities, not futures. As a result, first, such advisors are already fully regulated in such activities by the SEC as registered investment advisers. And, second, financial futures are used by such advisors not for speculative trading, but only as a useful and important tool in the modern management of securities portfolios.

Before discussing some of the important uses of financial futures in the management of securities portfolios, it is important to first note some salient characteristics of the financial futures markets that enable futures contracts to be such effective management tools. The futures markets, in U.S. Treasury securities in particular, are large and liquid. Indeed, on some days a greater market value of Treasury Bond futures contracts is traded on the Chicago Board of Trade than there are actual U.S. Treasury securities traded in the Treasury market itself. This liquidity means that futures transactions can often be accomplished much more quickly than transactions in the securities markets and with less market impact and, consequently, with lower transaction costs. In addition, commission costs are lower for futures transactions than are commission costs or dealer spreads for stock or bond transactions. These qualities make futures extremely useful in implementing strategies in a securities portfolio--particularly if timing is important.

Large investment programs of institutional investors take time to implement. The portfolio manager must select appropriate securities to purchase or sell and must effect these purchases or sales gradually so that the transactions do not have an unfavorable impact on the securities' market prices. As a result, efficient execution of a large investment program often takes days, weeks or even months to complete. During this time the market can move as a result of changes in interest rates or stock prices before the investment program is completed. The portfolio manager who is able to use futures can hedge against such adverse market movements by buying or selling financial futures contracts--because of market liquidity the futures transaction can be effected swiftly--and, thus, permit the portfolio manager the time needed to complete the planned investment program in an orderly manner.

Thus, the manager of a bond fund may be concerned about a possible decline in interest rates and the resulting increase in market price of debt securities that the manager intends to acquire in an orderly way. That manager may accordingly purchase an interest rate futures contract to hedge against that anticipated increase in the price of the debt securities it intends to purchase. On the other hand, a portfolio manager who fears a temporary market decline may sell futures to offset an anticipated decline in the value of portfolio securities; the short futures position would be terminated when the portfolio manager is no longer concerned about market weakness. This hedging strategy may be a sensible alternative to the sale of portfolio securities and possible reinvestment later. Indeed, it often makes no sense to sell a substantial portion of a well-designed securities portfolio as a means of temporarily reducing market risk and later restoring that portfolio at a significant cost.

In addition, because the sale or purchase of interest rate futures may be used to produce the economic equivalent of increasing or reducing a portfolio's holdings of either short term investments or long term bonds, and because these transactions can be accomplished more quickly and cheaply than the equivalent securities transactions, futures can be used to adjust the duration of a fixed-income portfolio in response to changing interest rates or changing liabilities. Stock index futures contracts and options on future contracts can be used in equally useful and non-speculative ways in the management of portfolios of securities.

The usefulness of futures and related options is now widely acknowledged by institutional investment managers. Indeed, many of the sophisticated clients of such managers--such as pension funds--have become aware of the benefits that use of the futures market can bring to the management of their portfolios and are increasingly requesting that their investment managers use these instruments. It is not uncommon for pension funds who are seeking a new investment manager to ask about the manager's ability to use futures and options on futures in managing their portfolios. Moreover, in order to design competitive new investment products, such as mutual funds, it makes good business sense to incorporate appropriate uses of futures and options on futures. However, at present, apart from the limited and inadequate 15-person exemption, institutional investment advisors such as insurance companies can use futures and options on futures in advisory accounts only upon registration and regulation under the Commodity Exchange Act. Thus, unless the regulatory framework is changed, investment advisors such as ourselves will be constrained from designing such products and from using these instruments in the management of our client portfolios in accordance with our best investment judgment. Certain of our clients may seek an advisor, such as a bank or trust company, which is not subject to such constraints.

It is essential that prompt action be taken to provide appropriate exemptions or regulatory relief so that institutional investment mangers can continue to be able to use the best available investment tools for the benefit of their clients without becoming subject to regulations which, as we now show, are burdensome, inappropriate and, where appropriate, already provide for on the federal level.

II. Regulation of Insurance Companies and Other Institutional Investment Managers As CTAs Is Unnecessary and Inappropriate

The 1974 Amendments to the Commodity Exchange Act that created the CFTC also established the regulatory framework for commodity market professionals such as FCMs, CPOs, and CTAs. Registration and recordkeeping requirements and antifraud standards analogous to those in the federal securities laws were created. With respect to CTS, "the legislative history indicates that the purpose of the 1974 amendments applicable to advisers was to discourage the enticement of unsuspecting traders, and to eliminate undesirable business practices." CFTC v. Savage, 611 F.2d 270, 285 (9th Cir. 1979).

But investment advisers registered with the SEC under the Investment Advisers Act of 1940 are already subject to regulation and supervision that provide the necessary protection. First, the Investment Advisers Act and the Commodity Exchange Act contain identical anti-fraud provisions. See 15 U.S.C. sec 80b-6 and 7 U.S.C. sec 60. Second, information concerning certain management personnel involved in developing or providing investment advice, including educational, business, and disciplinary histories, must be provided to the SEC on Form ADV. The SEC must also be provided with detailed information concerning the nature of the adviser's business, including generally the adviser's most recent balance sheet and descriptions of the fee arrangements, the types of advisory service provided, the adviser's sources of information and methods of analysis, and the investment strategies generally employed including whether futures and related options may be used. Form ADV, Part II. These registration requirements are substantially the same as those required of CTAs by the CFTC and the National Futures Association ("NFA") under Forms 7-R and 8-R.

Next, the investment Advisers Act requires advisers to make detailed disclosures to their clients, including at least the information contained in Part II of Form ADV, which details such items as fee arrangements, the basis of the adviser's techniques, and the use of futures. SEC Rule 204-3. Prospective investors in mutual funds advised by institutional advisers must be furnished with prospect uses which must contain a description of the fund's investment objectives and policies, the types of securities that will be purchased, and any special risk factors associated with the fund. 15 U.S.C. sec 77e. And with respect to pension plans advised by institutional advisers, ERISA establishes a system of fiduciary obligations that provides ample protections against the practices sought to be controlled by CTA registration and regulation. In each of these situations, then, there exist regulatory requirements that substantially duplicate all the appropriate information contained in the "Disclosure Document" that a CTA must furnish to its customers. 17 C.F.R. sec 4.31(a).

Registered investment advisers are also subject to appropriate requirements regarding recordkeeping, custody of clients' funds, and supervision of personnel, as well as to proscriptions on misleading advertising and fraudulent practices. Accordingly, an investment adviser registered as such with the SEC is already subject to the full panoply of appropriate federal regulation and supervision over all of its advisory activities regarding securities portfolios, including portfolios that may use financial futures or options. Thus, in sum, registration and regulation as a CTA is unnecessary and would be largely duplicative.

The problem is more than one of unnecessary and duplicative regulation, however. CTA regulation also imposes further duties that, because they were developed in connection with traditional CTAs in mind, are inappropriate and unwarranted as applied to institutional advisers who use futures in connection with the management of securities portfolios. First, under the rules of the CFTC and NFA, a CTA's principals (including, for example, the insurance company's board of directors) and associated persons must be fingerprinted so their true identity can be ascertained and background checks conducted. But the identity and business backgrounds of an investment adviser's directors and personnel are already disclosed in numerous regulatory filings and disclosure documents. Second, the NFA imposes examination requirements on persons who solicit discretionary accounts for CTAs and on those who supervise such persons; these "associated persons" are tested on the commodities markets generally, especially physical commodities, as well as CFTC regulations. This too is inappropriate for the employees of registered investment advisers. Such advisers employ commodities interests in the course of, and as an incident to, managing portfolios of securities. To the extent that commodity interests would be discussed in a sales presentation, it would be to explain the role of such interests in the management of securities portfolios. In addition, many of such persons are already registered with the NASD and have taken NASD and other examinations appropriate to the products they are licensed to sell.

Even more importantly, certain of the disclosure requirements imposed on CTAs are inappropriate and misleading when applied to institutional managers of securities portfolios. For example, a CTA must provide its prospective clients with a Disclosure Document that states the actual performance record over the past three years for all accounts directed by the CTA and its principals. This requirement for presentation of past performance was designed to provide potential customers with useful information regarding an advisor's success in trading or providing advice regarding the trading of commodity interests for speculative purposes. But institutional advisors use commodities instruments (i.e., financial futures and related options) primarily for hedging and risk management. Thus their commodity trading performance records would be irrelevant and indeed misleading, since such records would have no meaning except in light of, and in conjunction with, the overall performance of the entire securities portfolio. And a large institutional adviser such as an insurance company would have numerous accounts directed by it and its many "principals," many of which are non-advisory accounts and involve strategies unrelated to the adviser's investment management business. Similarly, the disclosure Document must include a lengthy and boldface "Risk Disclosure Statement" warning of the speculative nature of commodity futures trading. As already noted, however, institutional advisors use such futures to manage risk and in other non-speculative ways; hence the required warning would be misleading.

In short, the regulations applicable to CTAs are neither necessary nor appropriate to apply to institutional advisors using commodities interests in connection with the management of securities portfolios. Their imposition would also put institutional advisors at an unjustified competitive disadvantage. Insurance companies and other institutional advisors compete with banks and trust companies for the business of managing or advising large portfolios for clients such as pension plans, endowments, foundations, mutual funds, and others. Yet banks and trust companies are excluded from the definition of CTA in Section 2 of the Commodity Exchange Act. Thus, banks and trust companies are not subject to the very considerable expense, delay and inconvenience involved in CTA registration and regulation, including duplicative reports to the CFTC and NFA, fingerprinting requirements, and examinations. Indeed, we understand that the process of registering as a CTA with the NFA currently takes many months, a delay that is quite harmful from a business standpoint. In addition, banks and trust companies need not include the inappropriate and misleading materials required to be in a Disclosure Document, such as performance charts and Risk Disclosure Statements--materials that undoubtedly would, for no valid reason diminish the institutional advisor's ability to compete with banks and trust companies in developing business.

III. Requested Legislative Action

We believe that the Congress should amend the definition of CTA in 7 U.S.C. sec 2 to add an exclusion for "any investment adviser registered as such with the Securities and Exchange Commission under the Investment Advisers Act of 1940 whose advice concerning commodities is in connection with the management of securities portfolios of institutional investors (including but not limited to banks, insurance companies, registered investment companies, financial institutions, corporations, charitable foundations, and single-employer and multi-employer employee welfare, pension and profit sharing plans and trusts).[2] This would put registered institutional investment advisers doing such a business on the same competitive footing as banks and trust companies. The exclusion would permit registered institutional investment advisers to use financial futures and related options in the management of equity and debt portfolios of institutional clients. In addition to the fully adequate regulation applicable to registered advisers, the fact that the proposed exclusion is limited to institutional investors provides further protection. Such investors are generally subject to their own regulatory schemes regarding permissible investments (as the CFTC's Rule 4.5 recognizes) and are, in any event, sophisticated investors.

As an alternative, the Committee could, by language in its Report, propose that the CFTC take regulatory action excluding such advisers from the definition of a CTA. The CFTC already has the power to exclude from the definition of a CTA "such other persons not within the intent of this definition." 7 U.S.C. sec 2. In 1982, this Committee concluded not to adopt an amendment exempting certain otherwise regulated persons using future or options for limited purposes from the statutory definition of "commodity pool operator," but instead expressed its view that such persons were not within the intent of the definition of that term. S.Rep.No. 384, 97th Cong., 2d Sess. 80 (1982). Thereafter, the CFTC on February 8, 1984 proposed a rule creating such an exemption, and a final rule was adopted on April 23, 1985.

We believe that either direct legislation or a specific proposal of regulatory relief by this Committee to the CFTC is necessary to ensure an expeditious resolution to these problems, which is vital. The Commission has long been aware of the problem of CTA registration and regulation for institutional investment advisers. Indeed, when it proposed the CPO exemption for otherwise regulated entities on February 8, 1984, the CFTC indicated that "in furtherance of the purpose of the [Senate] Committee Report" it was considering providing some (albeit inadequate) exemptive relief for otherwise regulated entities from CTA registration and regulation. But despite receiving comments at that time urging that such regulated entities be excluded from the definition of CTA, the CFTC has yet to propose any rule on the issue. Nor has adequate relief been given through individual exemptions or no-action positions.

As just noted, the Commission's February 8, 1984 proposal for relief on the CTA issue was plainly inadequate. The proposed exemption would have been limited to advisors formed for the sole purpose of providing advice to a single entity that qualified for exclusion from the definition of commodity pool under Rule 4.5. That limitation, however, had no justification. The facts that an advisor was formed long ago for another purpose (e.g., to conduct a life insurance business), and that it advises more than one client, have no relationship to whether regulation as a CTA is necessary or appropriate. As discussed above, in fact, such regulation is neither in these circumstances.

The CFTC has similarly adopted an overly narrow view of the Act's exclusion from the definition of a CTA of "the fiduciary of any defined benefit plan which is subject to the provisions of" ERISA. 7 U.S.C. sec 2. It is clear that insurance companies or other institutional investment advisers to defined benefit plans, as the "designated investment manager," 29 U.S.C. sec 1002(38), are fiduciaries as to each such plan. Yet the CFTC has adopted regulations which purport to limit the statutory exclusion to the "named fiduciary, the trustee, or any fiduciary whose sole business is to advise the plan." 17 C.F.R. sec 1.3(hh). This limitation, again, is not justified. Regulation of investment manager-fiduciaries under ERISA is not decreased either because the fiduciary is not named or because such management is not the fiduciary's sole business. We believe that the CFTC's attempt to restrict the statutory exclusion for ERISA fiduciaries of defined benefit plans should be disapproved by the Committee. In any event, however, this unjustifiably narrow interpretive regulation confirms our view that legislation or other direction to the CFTC from this Committee is needed regarding the inappropriateness of subjecting registered investment advisers to regulation as CTAs simply because they use futures in managing institutional securities portfolios.

Decisive action by this Committee--whether by legislation or by advising the CFTC to use its existing exemptive authority--is also needed because the need for relief from these inappropriate registration and regulation requirements is becoming critical. Institutional advisors are presently relying on the exemption from registration from advisors with no more than 15 clients, but that limit is fast approaching for at lease some of the advisors. Once the limit is reached, such advisors will unfairly have to choose between undergoing the registration process and complying with ill-suited regulations or foregoing clients who wish to take advantage of the new and beneficial techniques for risk management made possible by the use of commodities interests. Such a choice obviously puts insurance companies and other institutional investment managers at an unjustified competitive disadvantage as against banks and trust companies. It also inappropriately prevents insurance companies and other institutional money managers from making such services available to their current clients.

Accordingly, we respectfully urge the Committee to amend Section 2 of the Commodity Exchange Act to provide an exclusion for registered investment advisers whose advice concerning commodities is in connection with the management of institutional securities portfolios, or, at a minimum, to advise the Commission in the Committee's Report of the importance of proceeding forthwith to grant exemptive relief to such advisers.

FOOTNOTES FOR PRUDENTIAL, METROPOLITAN LIFE, AND EQUITABLE LIFE

1/ This includes, for instance, the need identified in the testimony of Mr. Seevers of Goldman, Sachs & Co. to formulate an updated definition of hedging that recognizes the concept of prudent risk management by institutional investment managers.

2/ Thus, Section 2(a)(1)(A) of the Commodity Exchange Act would be revised in pertinent part as follows:

> "The term 'commodity trading advisor' shall mean any person who, for compensation or profit, engages in the business of advising others, either directly or through publications, writings or electronic media, as to the value of or the advisability of trading in any contract of sale of a commodity for future delivery made or to be made on or subject to the rules of a contract market, any commodity option authorized under section 4c, or any leverage transaction authorized under section 19, or who, for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning any of the foregoing; but such term does not include (i) any bank or trust company or any person acting as an employee thereof, (ii) any news reporter, news columnist, or news editor of the print or electronic media, or any lawyer, accountant, or teacher, (iii) any floor broker or futures commission merchant, (iv) the publisher or producer of any print or electronic data of general and regular dissemination, including its employees, (v) the fiduciary of any defined benefit plan which is subject to the provisions of the Employee Retirement Income Security Act of 1974, (vi) any contract market, (vii) any investment adviser registered as such with the Securities and Exchange Commission under the Investment Advisers Act of 1940 whose advice concerning commodities is in connection with the management of securities portfolios of institutional investors (including but not limited to banks, insurance companies, registered investment companies, financial institutions, corporations, charitable foundations, and single-employer and multi-employer employee welfare, pension and profit sharing plans and trusts), and (vii) such other persons not within the intent of this definition as the Commission may specify by rule, regulation, or order:
>
> Provided, That the furnishing of such services by the foregoing persons is solely incidental to the conduct of their business or profession: Provided further, That the Commission, by rule or regulation, may include within this definition, any person advising as to the value of commodities or issuing reports or analyses concerning commodities if the Commission determines that such rule or regulation will effectuate the purposes of this provision."

II

99TH CONGRESS
2D SESSION

S. 2045

To amend the Commodity Exchange Act to reauthorize appropriations to carry out such Act, and for other purposes.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 4 (legislative day, JANUARY 27), 1986

Mr. HELMS (for himself and Mr. LUGAR) (by request) introduced the following bill; which was read twice and referred to the Committee on Agriculture, Nutrition, and Forestry

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A BILL

To amend the Commodity Exchange Act to reauthorize appropriations to carry out such Act, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Futures Trading Act of 1986".

TITLE I—ENFORCEMENT AND APPELLATE REVIEW

SEC. 101. FRAUDULENT PRACTICES.

Clause (2) of the first sentence of section 4b of the Commodity Exchange Act (7 U.S.C. 6b) is amended by striking out "on or subject to the rules of any contract market,".

SEC. 102. EXTRATERRITORIAL SERVICE OF SUBPOENAS.

Section 6(b) of the Commodity Exchange Act (7 U.S.C. 15) is amended—

(1) in the fourth sentence, by striking out "or any State" and inserting in lieu thereof ", any State, or any foreign country or jurisdiction"; and

(2) by inserting after the fourth sentence the following new sentence: "A subpoena issued under this section may be served upon any person who is not to be found within the territorial jurisdiction of any court of the United States in such manner as the Federal Rules of Civil Procedure prescribe for service of process in a foreign country.".

SEC. 103. EX PARTE APPOINTMENT OF TEMPORARY RECEIVERS.

The proviso of the first sentence of section 6c of the Commodity Exchange Act (7 U.S.C. 13a–1) is amended by inserting before the close parenthesis within the parenthetical phrase the following: ", and other than an order appointing a temporary receiver to administer such restraining order and to perform such other duties as the court may consider appropriate".

SEC. 104. COURT OF APPEALS REVIEW.

The Commodity Exchange Act is amended by adding after section 23 (7 U.S.C. 26) the following new section:

"SEC. 24. (a)(1) Except in cases in which judicial review of Commission action is otherwise expressly provided for in this Act, any person adversely affected by a final order of the Commission or by any rule adopted by the Commission under this Act may obtain review of the order or rule only in the United States court of appeals for the circuit in which the person resides or has its principal place of business.

"(2) To obtain the review, the person must file in the court within 30 days after notice of the order, or the promulgation of the rule, a written petition requesting that the order be modified or set aside in whole or in part or that the rule be set aside.

"(b) On the filing of the petition, the clerk of the court shall transmit a copy of the petition to the Commission.

"(c) On receipt of the petition, the Commission shall file in the court the record on which the order complained of is entered (in accordance with section 2112 of title 28, United States Code) or in the case of the rule under review, the rulemaking record of the Commission (including all written submissions), the transcript of any oral presentations made during the course of the rulemaking, and any other materials prescribed by the court.

"(d) No objection to the order or rule of the Commission shall be considered by the court unless the objection shall have been presented to and heard before the Commission.

"(e) On the filing of the petition, the court may affirm the issuance of the order or the adoption of the rule, set aside or modify the order, or set aside the rule.

"(f) The findings of the Commission as to the facts shall be conclusive if supported by substantial evidence.".

TITLE II—LEVERAGE TRANSACTIONS

SEC. 201. DEFINITIONS.

Section 2(a)(1)(A) of the Commodity Exchange Act (7 U.S.C. 2) is amended—

(1) in the first proviso of the third sentence (relating to the definition of the term "commodity"), by striking out ", and transactions subject to regulation by the Commission pursuant to section 19 of this Act"; and

(2) in the sixteenth sentence (relating to the definition of the term "commodity trading advisor")—

(A) by striking out the comma after "a contract market" and inserting in lieu thereof "or"; and

(B) by striking out "or any leverage transaction authorized under section 19,".

SEC. 202. PENALTY FOR MANIPULATION OF PRICES.

The first sentence of section 9(b) of the Commodity Exchange Act (7 U.S.C. 13(b)) is amended—

(1) by striking out the comma after "4h" and inserting in lieu thereof "or"; and

(2) by striking out ", or section 19".

SEC. 203. PENALTY FOR PROHIBITED TRANSACTIONS.

The first sentence of section 9(d) of the Commodity Exchange Act (7 U.S.C. 13(d)) is amended by striking out "or any transaction for the delivery of any commodity under a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract, or under any contract, account, arrangement, scheme, or device that the Commission determines serves the same function or functions as such a standardized contract, or is marketed or managed in substantially the same manner as such a standardized contract,".

SEC. 204. PENALTY FOR USE OF NONPUBLIC INFORMATION.

Section 9(e) of the Commodity Exchange Act (7 U.S.C. 13(e)) is amended by striking out each place it appears the following: ", or in any transaction for the delivery of any commodity under a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract, or under any contract, account, arrangement, scheme, or device that the Commission determines serves the same function or functions as such a standardized contract, or is marketed or managed in substantially the same manner as such a standardized contract".

SEC. 205. RELATION TO OTHER LAWS.

Section 12(e)(2) of the Commodity Exchange Act (7 U.S.C. 16(e)(2)) is amended by striking out "or 19".

SEC. 206. LEVERAGE TRANSACTIONS.

Section 19 of the Commodity Exchange Act (7 U.S.C. 23) is repealed.

SEC. 207. PRIVATE RIGHT OF ACTION.

Section 22(a)(1)(C) of the Commodity Exchange Act (7 U.S.C. 25(a)(1)(C)) is amended—

(1) by inserting "or" after the semicolon at the end of clause (i);

(2) by striking out clause (ii); and

(3) by redesignating clause (iii) as clause (ii).

TITLE III—REGISTERED FUTURES ASSOCIATIONS

SEC. 301. DISCIPLINARY ACTIONS.

Subsection (h) of section 17 of the Commodity Exchange Act (7 U.S.C. 21(h)) is amended to read as follows:

"(h)(1)(A) If any registered futures association takes any final disciplinary action against any member of the association or any person associated with such a member or denies admission to any person seeking membership in the association, or bars any person from being associated with a member, the association shall promptly file notice thereof with the Commission.

"(B) The notice shall be in such form and contain such information as the Commission, by rule, may prescribe as necessary or appropriate to carry out the purposes of this Act.

"(2)(A) Any action with respect to which a registered futures association is required by paragraph (1) to file notice shall be subject to review by the Commission—

"(i) on the motion of the Commission; or

"(ii) on application by any person aggrieved by the action filed within—

"(I) 30 days after the date the notice was filed with the Commission and received by the aggrieved person; or

"(II) such longer period as the Commission may determine.

"(B) Application to the Commission for review, or the institution of review by the Commission on the motion of the Commission, shall not operate as a stay of the action unless the Commission otherwise orders, summarily or after notice and opportunity for hearing on the question of a stay (which hearing may consist solely of the submission of affidavits or presentation of oral arguments).

"(C) The Commission shall establish for appropriate cases an expedited procedure for consideration and determination of the question of a stay.".

SEC. 302. COMMISSION REVIEW OF ASSOCIATION ACTION.

Subsection (i) of section 17 of the Commodity Exchange Act (7 U.S.C. 21(i)) is amended to read as follows:

"(i)(1) In a proceeding to review a final disciplinary action taken by a registered futures association against a member thereof or a person associated with a member, after appropriate notice and opportunity for hearing (which hearing may consist solely of consideration of the record before the association and opportunity for the presentation of supporting reasons to affirm, modify, or set aside the sanction)—

"(A) if the Commission finds—

"(i) on the basis of the record in the proceeding before the association and such other matters as may be presented to the Commission, that the member or person associated with a member has engaged in such acts or practices or has omitted such acts;

"(ii) that the acts or practices, or omissions to act, are in violation of the rules of the association as have been specified in the determination of the association; and

"(iii) that the rules of the association are and were applied in a manner consistent with this Act,

the Commission, by order, shall so declare and, as appropriate, affirm the sanction imposed by the association, modify the sanction in accordance with paragraph (2), or remand the case to the association for further proceedings; or

"(B) if the Commission does not make any such finding, the Commission shall by order—

"(i) set aside the sanction imposed by the association; and

"(ii) if appropriate, remand the case to the association for further proceedings.

"(2) If, after a proceeding conducted in accordance with paragraph (1), the Commission finds that any penalty imposed on a member or person associated with a member is excessive or oppressive, with due regard for the public interest, the Commission shall by order cancel, reduce, or require the remission of the penalty.

"(3) In any proceeding to review the denial of membership in a registered futures association or the barring of any person from being associated with a member, if the Commission, after appropriate notice and hearing (which hearing may consist solely of consideration of the record before the association and opportunity for the presentation of supporting reasons to affirm, modify, or set aside the sanction), determines that—

"(A) the specific grounds on which the denial or bar is based exist in fact;

"(B) the denial or bar is in accordance with the rules of the association; and

"(C) the rules are and were applied in a manner consistent with this Act,

the Commission shall by order dismiss the proceeding or set aside the action of the association and require the association to admit the applicant to membership in the association or to permit the person to be associated with a member.

"(4) Any person (other than a registered futures association) aggrieved by a final order of the Commission entered under this subsection may file a petition for review with a United States court of appeals in accordance with section 6(b).".

SEC. 303. RULE REVIEW PROCEDURES.

Section 17(j) of the Commodity Exchange Act (7 U.S.C. 21(j)) is amended by striking out the third sentence.

SEC. 304. ALTERATION OR SUPPLEMENTATION OF ASSOCIATION RULES.

Section 17(k) of the Commodity Exchange Act (7 U.S.C. 21(k)) is amended—

(1) in paragraph (1), by striking out "title" and inserting in lieu thereof "section"; and

(2) by striking out paragraph (2) and inserting in lieu thereof the following new paragraph:

"(2)(A) The Commission may in writing request that any registered futures association adopt any specified alteration or supplement to the rules of the association with respect to any of the matters specified in this paragraph.

"(B) If the association fails to adopt the alteration or supplement within a reasonable time, the Commission is authorized by order to alter or supplement the rules of the association—

"(i) in the manner requested under subparagraph (A); or

"(ii) with such modification as the Commission considers necessary if, after appropriate notice and opportunity for hearing, it appears to the Commission that the alteration or supplement is necessary or appropriate in the public interest—

"(I) to assure fair dealing by the members of the association;

"(II) to assure a fair representation of the members of the association in the administration of the affairs of the association; or

"(III) to effectuate the purposes of this section.

"(C) The alterations or supplements may specify changes with respect to matters such as—

"(i) the basis for, and procedure in connection with, the denial of membership or the barring from being associated with a member or the disciplining of members or persons associated with members, or the qualifications required for members or natural persons associated with members or any class of members;

"(ii) the method of adoption of any change in or addition to the rules of the association;

"(iii) the method of choosing officers and directors;

"(iv) safeguards with respect to the financial responsibility of members;

"(v) the manner, method, and place of soliciting business by members, including the content of the solicitations; and

"(vi) the form and manner of handling, recording, and accounting for orders, transactions, and accounts of customers by members.".

TITLE IV—MISCELLANEOUS AMENDMENTS

SEC. 401. CERTAIN PROHIBITED TRANSACTIONS.

Section 9(d) of the Commodity Exchange Act (7 U.S.C. 13(d)) is amended—

(1) in the first sentence, by inserting before the period at the end thereof the following: "if nonpublic information is used in the investment transaction, if the investment transaction is prohibited by rule or regulation of the Commission, or if the investment transaction is effected by means of any instrument regulated by the Commission, except that the prohibitions specified in this sentence shall not apply to any transaction or class of transactions that the Commission, by rule or regulation, has determined would not be contrary to the public interest or otherwise inconsistent with the purposes of this section"; and

(2) by striking out the second and third sentences.

SEC. 402. AUTHORIZATION FOR APPROPRIATIONS.

Subsection (d) of section 12 of the Commodity Exchange Act (7 U.S.C. 16(d)) is amended to read as follows:

"(d) There are authorized to be appropriated to carry out this Act such sums as may be required for each of the fiscal years during the period beginning October 1, 1986, and ending September 30, 1992.".